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Regulatory Impact of Dodd-Frank Bill on Investment Advisers and Fund Managers

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Sprinkled among the 2,300+ pages of the Dodd-Frank Wall Street Reform and Consumer Protection Act are a number of provisions that will affect both registered investment advisers and other wealth managers who may not have registered as investment advisers up until now.

Impact on Existing Registered Investment Advisers

Effective one year after Dodd-Frank's passage, July 21, 2011, the dollar thresholds for determining whether an adviser is to register under federal or state law will change. Currently, advisers with assets under management of under $25 million must register with a state regulator, those with assets under management of between $25 million and $30 million may choose either state or federal regulation, and those with assets under management exceeding $30 million must register federally with the SEC. Under Dodd-Frank, generally all advisers with assets under management of under $100 million must register with state regulators and those with over $100 million under management must register with the SEC. Exceptions to this rule are advisers with assets of less than $25 million which do business in 30 or more states, or those with assets between $25 million and $200 million which do business in 15 or more states – they are permitted but not required to register with the SEC. So advisers now registered with the SEC but whose assets under management fall into the $25 million to $100 million category will be required to withdraw their SEC registration (by filing a Form ADV-W on the IARD system) and then refiling with one or more states. More guidance on appropriate procedures can be expected from the SEC and states prior to the July 21, 2011 deadline.

Registered investment advisers generally may only charge performance-based fees (i.e. fees based on investment success rather than the usual percentage-of-managed-assets fees) to "qualified clients." Qualified clients have been defined as those with either $750,000 or more of funds under management or having over $1,500,000 net worth. These thresholds have remained unchanged for many years; Dodd-Frank now requires the SEC to adjust them for inflation, starting within one year of the bill's enactment and every five years thereafter. This will almost certainly reduce the potential number of clients eligible for performance fee arrangements.

Registered advisers which sponsor or advise pooled investment funds (hedge funds and the like, now called "private funds") will be impacted in a couple of different ways. First, the potential universe of investors in such funds will shrink since Dodd-Frank now requires the SEC to re-write its definition of "accredited investors." Since the advent of the SEC's Regulation D in the early 1980's, the definition was set as natural persons with either $200,000 of annual income ($300,000 for couples) or $1 million of net worth (including one's residence). Dodd-Frank mandates that personal residences be excluded from the net worth calculation and that the thresholds be inflation-indexed. So the number of potential investors in these funds will inevitably decrease.

Second, Dodd-Frank requires sponsors of private funds to maintain voluminous records for the funds, available for SEC examination and to the new Financial Stability Oversight Council, as well as to investors. The required records include, among others, documentation of leverage, counterparty risk exposure, trading practices and "such other information" as the regulators may deem appropriate. Hedge funds will become more like registered mutual funds in many respects.

Dodd-Frank requires the SEC to review and analyze the need for enhanced examination and enforcement resources for its oversight of investment advisers and report back to Congress in 180 days. Among the issues required to be considered is whether the SEC should designate a self-regulatory organization (such as FINRA) to become involved in investment adviser oversight and examination. If that happens, then investment advisers, like broker-dealers now, can expect examinations by both the SEC and FINRA.

Impact on Previously Unregistered Wealth Advisors

The Investment Advisers Act of 1940 had from its inception an exemption from the registration requirement for advisers with less than 15 clients who did not hold themselves out to the public as investment advisers. Much of the hedge fund industry was built upon fund sponsors which avoid Adviser Act registration since a hedge fund with multiple investors of its own counted as only one client for Adviser Act purposes. The SEC attempted to circumvent this perceived loophole by a rule in 2005 that required a look-through of hedge funds to their investors for this purpose, but the rule was invalidated by the U.S. Court of Appeals which ruled it exceeded the SEC's statutory authority. Dodd-Frank has now eliminated the under-15 client exemption altogether, replacing it with several more narrow exemptions:

- certain foreign advisers with no place of business and less than 15 U.S. clients and less than $25 million of assets under management are exempt.
- advisers exclusively to "venture capital funds" (to be defined by the SEC within one year) are exempt. Not to be confused with advisers to "private equity funds" which will not be exempt; distinguishing them definitionally will be interesting.
- advisers exclusively to "family offices," also to be defined by the SEC.
- advisers exclusively to Small Business Investment Companies (SBICs), presumably because SBICs are closely regulated by the Small Business Administration.
- intrastate advisers, defined as those with clients only in one state and which do not advise as to listed securities. Of course, state regulation will still apply.
- Advisers exclusively to "private funds," i.e. hedge funds, private equity funds, etc. which fall outside the definition of an investment company, and have under $150 million of assets. So there is still room for a small hedge fund without direct SEC regulation.

Dodd-Frank also wades into the issue of financial planner regulation. Financial planners who do not advise as to particular investments have heretofore avoided regulation as investment advisers or otherwise. Dodd-Frank requires the Comptroller General of the United States to conduct a study to determine whether financial planners should now be regulated.

Conclusions

Dodd-Frank continues the trend of the last ten years of ever-increasing regulation of investment advisers, with the prospect of still higher costs of compliance.