Morgan Lewis

alert

financial regulatory reform lawflash

www.morganlewis.com

Dodd-Frank Wall Street Reform and Consumer Protection Act: Summary of Provisions of Primary Interest to Advisers

Among the many reforms to occur due to the recent passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, some provisions will specifically impact the business of those investment advisers registered under the Advisers Act.

July 28, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Wall Street Reform Act), signed into law by President Obama on July 21, will affect a very broad spectrum of financial activity in the United States. A number of its provisions will amend the Investment Advisers Act of 1940 (the Advisers Act) and impact the businesses of investment advisers registered under the Advisers Act (RIAs).

This update summarizes the provisions of the Wall Street Reform Act that may be expected to have the most significant impact on RIAs immediately and in the near term. Unless otherwise noted, the provisions of the Wall Street Reform Act become effective one year from the date of enactment (i.e., July 21, 2011) in order to allow those affected to transition to the new requirements.

Eligibility for SEC Registration

The Advisers Act currently allocates responsibility for oversight of investment advisers between the U.S. Securities and Exchange Commission (SEC) and the various state securities regulators. Currently, the Advisers Act generally *requires* investment advisers with $30 million in assets under management to register with the SEC, while investment advisers with between $25 million and $30 million in assets under management *may* register with the SEC. In addition, certain investment advisers with less than $25 million in assets under management *may* register with the SEC if they meet certain other requirements.

The Wall Street Reform Act amends the Advisers Act to provide, in substance, that an investment adviser may not register with the SEC unless it has $100 million in assets under management, unless it satisfies an exception to the new $100 million requirement. The key exceptions apply to (i) advisers to registered investment companies, (ii) advisers that would be required to register with 15 or more states, and (iii) advisers that would not be subject to registration *and* examinations by their home states.

Note that the Wall Street Reform Act effectively reduces the number of states in which an RIA would have to be registered to qualify for the multistate exemption under Rule 203A-2(e), from 30 to 15 states. In addition, we expect that investment advisers that do not have $100 million in assets under

management could continue to register with the SEC under Advisers Act Rule 203A-2, if they are affiliated with an adviser that is eligible to register with the SEC, or otherwise qualify as a nationally recognized statistical rating organization (NRSRO), pension consultant, or Internet investment adviser.

In addition, the following will be affected by the amending of the Advisers Act:

- The Investment Advisers Association preliminarily estimates that the new $100 million assets under management requirement will disqualify between 3,500 and 4,000 investment advisers from maintaining current registration with the SEC.
- It is unclear exactly how exception (iii) above will be applied in states such as New York, which require registration of investment advisers, but do not have a regular adviser examination program.
- Regardless of assets under management, an investment adviser would not be eligible for SEC registration if it is not required to register as an investment adviser in the state in which it maintains its principal office and place of business.
- Investment advisers that are now eligible to register with the SEC for the first time under the Wall Street Reform Act changes may register with the SEC prior to the July 21, 2011 effective date.

RIAs that currently have between $25 million and $100 million in assets under management will need to consider whether they are eligible to remain registered with the SEC. If not eligible, they will have to prepare to deregister with the SEC and evaluate state adviser registration requirements.

Investment Advisers to Private Funds

The Wall Street Reform Act amends the Advisers Act to require that most investment advisers to private funds (i.e., funds formed in reliance on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940) to register with the SEC and imposes significant new reporting requirements for advisers to private funds. It also includes a variety of exceptions to the registration requirements for certain categories of private fund advisers. Morgan Lewis has produced a separate Financial Regulatory Reform LawFlash, titled "Private Fund Investment Advisers Registration Act Enacted Into Law," (July 28, 2010), which addresses new requirements for private fund advisers in detail and is available online at http://www.morganlewis.com/pubs/FRR_PrivateFundInvestmentAdvisersRegAct_LF_28jul10.pdf.

Investor and Client Qualification Standards

Advisers frequently advise clients with respect to investments in offerings that are made by issuers in reliance on SEC regulations that permit private offerings to "accredited investors" (for example, Rule 506 under the Securities Act of 1933). Advisers also may sponsor their own private funds that make offerings only to accredited investors. Currently, an individual may qualify as an accredited investor if the individual has a net worth of $1 million or more, including the value of his or her primary residence. The Wall Street Reform Act requires the SEC to adjust upward the net-worth standard for an accredited investor, but also specifies that the net-worth requirement shall remain $1million for four years from the date of enactment (i.e., beginning immediately), *but shall now exclude the value of the individual's primary residence*.

RIAs that advise individual clients with regard to investments that require the client to be an accredited investor should confirm that their clients continue to be eligible to make such investments. RIAs that themselves sponsor funds that are offered only to accredited investors should take steps to amend subscription agreements and investor questionnaires as necessary.

The Advisers Act prohibits RIAs from charging performance-based fees to clients. However, as authorized by the Advisers Act, the SEC has adopted Rule 205-3, which permits RIAs to charge a performance-based fee to "qualified clients." Currently, as defined in Rule 205-3, qualified clients include clients who have assets under management with the RIA of $750,000 or more, and clients who have a net worth of $1.5 million or more. The Wall Street Reform Act directs the SEC to adjust the qualified client requirements for inflation within one year of the date of enactment, and every five years thereafter.

RIAs that charge performance fees should prepare to track changes in the definition of qualified client. This preparation should include tracking the effects of the changes on both managed account clients and investors in a pooled investment vehicle managed by the RIA.

Relief for Family Offices

The Wall Street Reform Act amends the Advisers Act to carve out "family offices" from the definition of "investment adviser" and therefore, investment adviser regulation (other than antifraud rules). The Wall Street Reform Act tasks the SEC with defining the term "family office," subject to parameters set forth in the legislation.

SEC Rulemaking and Studies

The Wall Street Reform Act includes a number of provisions that expressly authorize the SEC to adopt rules under the Advisers Act and direct the SEC or Government Accounting Office (GAO) to conduct studies. While none of these provisions effect immediate changes for RIAs, it may be expected that the SEC will exercise its expanded rulemaking authority, and that the various studies may provide a basis for further congressional or SEC action. The following are some of the provisions that authorize rulemaking or mandate completion of studies that are most relevant to RIAs:

Rulemaking Authority

- The SEC shall "facilitate" (presumably, by rulemaking) the provision of simple and clear disclosures to investors regarding the terms of their relationship with investment advisers, including material conflicts of interest.

- The SEC shall examine and, where appropriate, promulgate rules prohibiting or restricting certain sales practices, conflicts of interest, and compensation schemes for investment advisers.

- The SEC may adopt rules to provide that the standard of conduct for all investment advisers shall be to act in the best interest of the customer without regard to the financial or other interest of the investment adviser.

- The SEC may adopt rules to prohibit or impose conditions or limitations on the ability of investment advisers to use predispute arbitration provisions in advisory contracts.

Studies

- The SEC shall study the effectiveness of existing legal or regulatory standards of care for investment advisers, and whether there are any legal or regulatory gaps or shortcomings in standards for the protection of investors. The SEC must report the results to Congress within six months.

- The SEC shall study the need for enhanced examination and enforcement resources for investment advisers.

If you have any questions or would like more information about any of the issues discussed in this LawFlash, please contact any of the following Morgan Lewis attorneys:

Washington, D.C.

Steven W. Stone	202.739.5453	sstone@morganlewis.com
Thomas S. Harman	202.739.5662	tharman@morganlewis.com
Monica Lea Parry	202.739.5692	mparry@morganlewis.com

Miami

Ethan W. Johnson	305.415.3394	ejohnson@morganlewis.com

New York

Jennifer L. Klass	212.309.7105	jklass@morganlewis.com

Philadelphia

Timothy Levin	215.963.5037	tlevin@morganlewis.com

In addition, Morgan Lewis's multidisciplinary Financial Regulatory Reform resource team is available to assist with a wide range of issues and areas of concern related to the reform effort. You can access a complete collection of the firm's updates and alerts on the subject on our website's Financial Regulatory Reform page.

About Morgan, Lewis & Bockius LLP

With 23 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, Minneapolis, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo, Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.

This FYI Alert is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as, and does not constitute, legal advice on any specific matter, nor does this message create an attorney-client relationship. These materials may be considered **Attorney Advertising** in some states.
Please note that the prior results discussed in the material do not guarantee similar outcomes.

© 2010 Morgan, Lewis & Bockius LLP. All Rights Reserved.