Dodd–Frank Act Expands Federal and State Regulation of Investment Advisers

by Thomas R. Stephens

This article analyzes the Dodd-Frank Act's recent revisions to federal regulation of investment advisers and the Act's impact on Colorado's blue sky regulation of investment advisers.

On July 21, 2010, President Barack Obama signed into law the Dodd–Frank Wall Street Reform and Consumer Protection Act, Title IV of which is the Private Fund Investment Advisers Registration Act of 2010 (Act). The Act will require the advisers and managers of many hedge funds and leveraged buyout funds, including some foreign advisers, to register with the U.S. Securities and Exchange Commission (SEC). The Act also expands the scope of state regulation of investment advisers by requiring mid-sized investment advisers that currently are registered with the SEC instead to register with the applicable states.[1] The Act generally goes into effect on July 21, 2011.

Additional regulation is not typically a plus for businesses, but the Act may turn out to have a silver lining for management personnel of larger hedge fund and private equity fund advisers in Colorado, who will be subject to an SEC regulatory regime that in a few key respects is less onerous than the existing regulatory regime in Colorado. For the adviser entity, though, the ongoing challenge of implementing and living under the SEC regime will be substantial. Mid-sized advisers that have been registered with the SEC will be subject to regulation by Colorado rather than the SEC and, as noted above, Colorado's registration process includes some additional requirements on management personnel of advisers that are not applicable under the SEC's registration process.[2] All affected advisers likely will incur additional cost and time commitments and will need to address the Act's changes well in advance of July 21, 2011, when the Act goes into effect.

Private Adviser Exemption Eliminated

The main thrust of the Act is to delete the so-called private adviser registration exemption formerly contained in Section 203(b)(3)[3] of the Investment Advisers Act of 1940 (Advisers Act).[4] Historically, managers of many hedge, real estate, and private equity funds used the exemption to avoid registration with the SEC. The exemption generally applied if the manager/adviser had fewer than fifteen clients and did not "hold [itself] out generally to the public" as an investment adviser.[5] Most hedge funds, venture capital funds, and leveraged buyout funds counted as a single client.[6] By taking the position that they had only a single client or a small number of clients, and by restricting marketing and public relations activities so as to avoid the "holding out" problem, advisers of these funds were not required to register with the SEC. Only the largest fund advisers, who had fifteen or more clients due to multiple funds or a combination of funds and non-fund-managed accounts or who were engaged in more extensive marketing or public relations activities, typically registered with the SEC. Advisers of public mutual funds (registered investment companies) and business development companies were required to register regardless of their number of clients and their marketing activities.

The Act makes a handful of other changes to the Advisers Act. The key changes include the addition of:

1) a new registration exemption for advisers to private funds with less than $150 million of assets (private funds are any investment company defined in Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (Investment Company Act));
2) a new registration exemption for foreign private advisers, essentially using the old private adviser exemption (fewer than fifteen clients) and applying it to advisers who have no place of business in the United States and manage less than $25 million attributable to clients in the United States;

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3) new registration exemptions defined by the SEC for family offices[7] and advisers to venture capital funds;[8] despite the exemption, advisers to venture capital funds will be required to maintain certain records and file reports with the SEC;
4) new registration exemptions for commodity trading advisers and advisers to small business investment companies; and
5) a new section of the Advisers Act concerning collection of systemic risk data and imposing additional record-keeping and examination requirements on registered advisers.[9]

Investment Advisers

Under both the Advisers Act and the Colorado Securities Act (Colorado Act), an investment adviser is:

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[10]

Both statutes specifically exclude a number of professionals and activities, such as publications (for example, newspapers and newsletters); broker–dealers (if no special compensation is received); depository institutions; lawyers; accountants; teachers; investment bankers; and licensed real estate brokers. However, the statutory language of the exceptions varies between the Advisers Act and the Colorado Act.[11] The statutes are consistent in clearly providing that the general partners and/or investment managers of hedge and private equity funds are investment advisers.[12]

Some advisers to private funds could undertake an analysis of whether their activities meet the definition of an investment adviser. For example, advisers to some real estate funds might take the position that they provide advice on real estate exclusively and not with respect to securities. Successfully arguing this position likely would require that the real estate fund not invest in mortgages, real estate investment trust or REIT stock, or debt securities (even if limited to real estate debt). Similarly, advisers to leveraged buyout funds might argue that they advise their funds on buying and selling businesses rather than on buying and selling securities. This argument would require, at a minimum, that such funds control (and perhaps own 100 percent of) their portfolio companies, so the adviser could argue that the funds invest solely in businesses and not securities. The argument would not be viable for hedge funds, funds of funds, or leveraged buyout funds that take significant minority positions or typically participate in "club" deals.[13]

The SEC probably would not react favorably to these arguments; the SEC typically has interpreted the concept of "advising as to securities" quite broadly, and may view the real estate or leveraged buyout fund advisers' positions as creating a troublesome loophole. In addition, fund documents themselves may prove problematic, because these documents typically contain investment adviser or investment manager language to describe the role of the fund's general partner or manager.

Federal and State Regulation

Regulation of investment advisers generally is split between the SEC and the various states, depending on the dollar amount of assets the adviser has under management. Under Section 203A(a)(1)(A) of the Advisers Act, investment advisers with assets of less than $25 million under management are prohibited from registering with the SEC and, as a result, may be required to register with various states, depending on state law.[14] The Act adds a new Section 203A(a)(2) to the Advisers Act, which will prohibit "mid-sized" investment advisers (those with assets under management of $25 million to $100 million) from registering with the SEC, unless the adviser would be subject to registration in at least fifteen states or unless the adviser is not required to be registered (and subject to examination) in its home state. Thus, implementation of the Act will force a number of federally registered advisers to register with the states instead of the SEC, effectively creating a significant expansion of state authority in this area.

Advisers of mutual funds register with the SEC,[15] regardless of the size of the fund, and multistate and Internet advisers also register with the SEC.[16] The SEC, by regulation, has permitted advisers with assets under management of between $25 million and $30 million to register with the states in lieu of registering with the SEC, although this regulation will be altered as a result of the Act.[17]

Federal Regulation

Under the SEC's rules, advisers registering with the SEC must electronically file the SEC's Form ADV, using the Investment Adviser Registration Depository (IARD) sponsored by the SEC and the North American Securities Administrators Association and operated by the Financial Industry Regulatory Authority (FINRA).[18] A filing fee must be paid to FINRA.[19] Once Form ADV is filed with the IARD, the SEC has forty-five days to deem the registration effective or institute proceedings to deny registration.[20]

Federal law creates a series of classifications for management personnel of investment advisers and other individuals associated with the adviser. These classifications include "supervised persons," "access persons," and "investment adviser representatives."

A supervised person is:

> any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser.[21]

Access persons are a subset of supervised persons. An access person is a supervised person "who has access to nonpublic information regarding any clients' purchase or sale of securities, or nonpublic information regarding the portfolio holdings of any reportable fund," or "who is involved in making securities recommendations to clients, or who has access to such recommendations that are nonpublic."[22] For advisers whose primary business is providing investment advice, all directors, officers, and partners are presumed to be access persons.[23]

Investment adviser representatives also are a subset of supervised persons. An investment adviser representative is:

> a supervised person of the investment adviser: (i) who has more than five clients who are natural persons (other than [qualified clients]); and (ii) more than ten percent of whose clients are natural persons (other than [qualified clients]).[24]

A supervised person is not an investment adviser representative

> if the supervised person: (i) does not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser; or (ii) provides only impersonal investment advice.[25]

The significance of these categories is twofold. First, the SEC's rules require federally registered investment advisers to adopt a code of ethics that imposes certain obligations on supervised persons and additional obligations on access persons. In particular, access persons must report all personal securities holdings and transactions to the adviser and must, in some cases, obtain preapproval of trades.[26]

Second, the Advisers Act preempts and bans state regulation of federally registered investment advisers and their supervised persons, other than investment adviser representatives.[27] Thus, a federally registered adviser is not subject to either state regulations in multiple states or state regulations that may be more extensive than the federal regulations. The Advisers Act also preempts and bans state regulation of various entities that are exempt from the investment adviser definition contained in the Advisers Act, such as depository institutions.[28] The Act's new family office exemption was included in the definition of investment adviser and, as a result, states will be banned from regulating family offices.[29]

Federally registered investment advisers are subject to a number of obligations created by the Advisers Act and expanded by the Act. Registered advisers must:

1) establish written compliance policies and procedures designed to prevent violations of the Advisers Act and designate a supervised person as a chief compliance officer[30]
2) adopt a written code of ethics, providing, among other things, that access persons must report their securities holdings and transactions to the chief compliance officer and obtain clearance in advance of acquisitions (although not dispositions) of any security issued in an initial public offering or in a limited offering;[31]
3) maintain certain books and records and make them available to the SEC during examinations;[32] the Act expanded the Advisers Act record-keeping requirements to include:
   - the amount of assets under management and use of leverage, including off-balance-sheet leverage
   - counter-party credit risk exposure
   - trading and investment positions
   - valuation policies and practices of the fund
   - types of assets held
   - side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors
   - trading practices
   - other information identified by the SEC;[33]
4) provide certain specified disclosures to clients (including investors in funds), generally Part II of Form ADV or a brochure containing similar information;[34]
5) comply with requirements relating to custody of client funds and securities;[35]
6) adopt written policies and procedures with respect to voting of client securities;[36] and
7) comply with the SEC's regulations regarding privacy of client information.[37]

Registration with the SEC also subjects investment advisers to the SEC's rules with respect to performance fees.[38] Registered advisers generally may charge performance fees only to "qualified clients"[39] and to private funds that qualify under Section 3(c)(7) of the Investment Company Act—that is, funds whose investors are solely qualified purchasers as defined under Section 2(a)(51)(A) of the Investment Company Act.[40] Qualified clients generally must have net worth of at least $1.5 million, have at least $750,000 under management by the adviser, be a qualified purchaser (as defined above), or be knowledgeable employees of the adviser.[41] A private fund described in Section 3(c)(1) of the Investment Company Act is a qualified client only if each investor in the private fund is a qualified client.[42]

Finally, and perhaps most significant, federal registration also subjects investment advisers to periodic examinations conducted by SEC staff. The SEC recently ceased trying to examine all registered advisers on a regular schedule, but instead focuses on advisers that are the subject of complaints and tips.[43]

Colorado's Regulatory Scheme

Colorado's regulatory scheme for investment advisers is contained in the Colorado Act, which went into effect in 1999.[44] Under the Colorado Act, a person with a place of business in Colorado cannot transact business in Colorado as an investment adviser unless the adviser is licensed or exempt from licensing.[45] However, the Colorado Act has a very narrow exemption from licensing: only advisers that do not have a place of business in Colorado are exempt from licensing.[46] Even advisers without a place of business in Colorado may be subject to Colorado's licensing requirements if they are not federally registered and have more than five clients in Colorado during a twelve-month period (unless the only clients are specified institutions).[47] As a result, the registration requirements for investment advisers in Colorado have been much broader than in certain other states.[48]

Federally registered advisers must file a notice with the Colorado Securities Commissioner.[49] Investment advisers registering with Colorado, as well as federally registered advisers filing the notice required by Colorado law, file the SEC's Form ADV with the IARD to become licensed or file a notice.[50]

Under the Colorado Act, an investment adviser cannot employ an individual with a place of business in Colorado as an investment adviser representative unless the individual is licensed or exempt from licensing.[51] Unlike the narrower federal definition quoted above, for Colorado law purposes, an investment adviser representative is:

> an individual who has a place of business in [Colorado]; who is a partner, officer, or director of an investment adviser; who occupies a status similar to or performs functions similar to those of a partner, officer, or director for an investment adviser; or who is employed or otherwise associated with an investment adviser who (i) makes recommendations or otherwise renders advice to clients regarding securities; (ii) manages securities accounts or portfolios for clients; (iii) determines which recommendation or advice regarding securities should be given to clients; or (iv) supervises employees of, or persons otherwise associated with, an investment adviser or a federal covered adviser who perform any of the duties specified in [this sentence].[52]

Thus, although the definition of an investment adviser representative for federally registered advisers generally is limited to representatives who advise natural persons, for Colorado registered advisers, the definition is quite broad. Of note, the Colorado definition of an investment adviser representative would apply to virtually all management-level individuals at hedge fund and private equity fund advisers. The significance of Colorado's expansive definition is that investment adviser representatives of Colorado registered advisers must file a Form U-4 with FINRA and complete FINRA's Series 65 Exam (the Uniform Investment Adviser Law Examination).[53]

Comparison of Federal and Colorado Regulation

The federal registration process is fairly simple; however, before registering, an investment adviser will invest substantial time and effort to adopt internal policies—including a code of ethics and a compliance manual—and to implement record-keeping procedures. By contrast, the Colorado registration process is more complicated and onerous, mainly because of the required Form U-4 and Series 65 Exams for investment adviser representatives. Once registered, however, federally registered investment advisers face a greater regulatory burden than Colorado registered investment advisers, primarily because of the scope of the periodic federal examinations and the detailed nature of federal regulations on matters such as the required code of ethics.

Conclusion

By July 21, 2011, the Act will both expand and reduce federal and Colorado regulation of investment advisers, depending on the level of assets under management. Federal regulation will be expanded to include many advisers formerly meeting the federal private adviser exemption, but will be reduced with respect to advisers with less than $100 million in assets under management (and advisers to private funds with less than $150 million in assets under management). Colorado's regulation of investment advisers—particularly advisers formerly meeting the federal private adviser exemption—will be preempted for advisers with more than $100 million under management ($150 million for advisers to private funds). However, Colorado's regulation will be expanded to include a new group of mid-sized advisers formerly subject to federal regulation.

The Act reduced the amount of regulation imposed on advisers of private funds in Colorado in one area. Within a year, advisers of private funds with assets of more than $150 million will move from Colorado to federal registration. This will be welcomed news for the management personnel of these advisers, because they no longer will have to file a Form U-4 and complete the Series 65 Exam (barring the very rare situation in which those individuals also have a sufficient number of clients who are natural persons and thereby meet the federal definition of an investment adviser representative).[54] The tradeoff for these advisers will be more extensive and onerous regulation under the SEC's regime; in particular, the SEC's examination process for registered advisers likely will be time consuming, and it remains to be seen how onerous the new record-keeping requirements will be.

Investment advisers of private funds with less than $150 million of assets under management will move in the other direction, transitioning from federal to Colorado registration. As mentioned above, management personnel of these advisers will be required to file a Form U-4 and complete the Series 65 Exam, although the adviser will be free from SEC examinations and other SEC registration requirements.

Notes

1. 15 U.S.C. § 80b-3A(a)(2). Mid-sized investment advisers generally are those with less than $100 million of assets under management.

2. The U.S. Securities and Exchange Commission (SEC) estimates that 4,100 advisers nationwide will cease to be regulated by the SEC but instead will be regulated by the states as a result of the increase in the minimum assets under management required for federal registration. *See* Investment Advisers Act Rel. No. IA-3110 (Nov. 19, 2010).

3. 17 C.F.R. § 275.203(b)(3). The Private Fund Investment Advisers Registration Act of 2010 (Act) also prohibits private fund advisers from relying on an existing intrastate exemption that, absent the changes in the Act, some private fund advisers might have been able to use to avoid registration.

4. 15 U.S.C. §§ 80b-1 *et seq*.

5. 17 C.F.R. § 275.203(b)(3).

6. *See* 17 C.F.R. § 275.203(b)(3)-1(a)(2)(i).

7. The SEC's proposed definition of a "family office" generally provides that the adviser must have no clients other than family clients, be controlled by family members, and not hold the adviser out to the public as an investment adviser. *See* Investment Advisers Act Release No. IA 3098 (Oct. 12, 2010).

8. The SEC's proposed definition of a "venture capital fund" generally provides that a private fund is a venture capital fund if, among other requirements: (1) it represents that it is a venture capital fund; (2) it owns solely cash, cash equivalents, and equity securities issued by one or more qualifying portfolio companies, provided that at least 80 percent of the equity securities of each qualifying portfolio company owned by the fund was acquired directly from the qualifying portfolio company; (3) it controls the portfolio company or offers to provide and, if accepted, provides significant guidance and counsel concerning the management, operations, or business objectives and policies of the qualifying portfolio company; (4) it does not have leverage in excess of 15 percent of the private fund's aggregate capital contributions and uncalled committed capital, and any such leverage is for a nonrenewable term of no longer than 120 calendar days; and (5) it does not issue securities that permit investors to withdraw, redeem, or require the repurchase of such securities. Existing venture capital funds generally are grandfathered provided that they have represented themselves as venture capital funds. *See* Investment Advisers Act Release No. IA-3111 (Nov. 19, 2010).

9. These records, which include items such as side letters with specific fund investors, will be subject to SEC inspection, but it appears they will not be subject to public disclosure under the Freedom of Information Act.

10. 15 U.S.C. § 80b-2; CRS § 11-51-201(9.5).

11. *Id.*

12. *Id.*

13. "Club" deals are used to describe acquisitions in which several funds act together to acquire a portfolio company.

14. 15 U.S.C. § 80b-3(a)(1)(A).

15. 15 U.S.C. § 80b-3(a)(1)(B).

16. 17 C.F.R. § 275.230A-2(e) and (f).

17. 17 C.F.R. § 275.203A-1(a)(1). The SEC has proposed to eliminate 17 C.F.R. § 275.203A-1(a)(1). *See* Investment Advisers Act Rel. No. IA-3110 (Nov. 19, 2010).

18. 17 C.F.R. § 275.203-1.

19. 17 C.F.R. § 275.203-1(d). In 2010, filling fees ranged from $40 to $200, depending on assets under management. *See* www.sec.gov/IARD.

20. 15 U.S.C. § 80b-3(c)(2).

21. 15 U.S.C. § 80b-2(a)(25).

22. 17 C.F.R. § 275.204A-1(e)(1).

23. *Id.*

24. 17 C.F.R. § 275.203A-3(a)(1). *See infra* note 41 and accompanying text (definition of "qualified client").

25. 17 C.F.R. § 275.203A-3(a).

26. 17 C.F.R. § 275.204A-1(b).

27. 15 U.S.C. § 80b-3a. States may bring enforcement actions against federally registered advisers for fraud or deceit, 15 U.S.C. § 80b-3a(b)(2).

In addition, states may require federally registered advisers to file Form ADV for notice purposes and pay state filing fees.

28. 15 U.S.C. § 80b-3A(b)(1)(B).

29. *See supra* note 7 and accompanying text.

30. 17 C.F.R. § 275.206(4)-7.

31. 17 C.F.R. § 275.204A-1.

32. 17 C.F.R. § 275.204-2. Records generally must be kept for five years under 17 C.F.R. § 275.204-2(e).

33. 15 U.S.C. § 80b-4(b)(3).

34. 17 C.F.R. § 275.204-3.

35. 17 C.F.R. § 275.206(4)-2. The custody rules typically would not apply to most securities held by leveraged buyout or venture capital funds, because the custody rules do not apply to privately offered securities. 17 C.F.R. § 275.206(4)-2(b)(2).

36. 17 C.F.R. § 275.206(4)-6.

37. 17 C.F.R. § 275.248 (Regulation S-P). Unregistered investment advisers must comply with Federal Trade Commission rules.

38. 15 U.S.C. § 80b-5.

39. 17 C.F.R. § 275.205-3(a).

40. 15 U.S.C. § 80b-5(b)(4).

41. 17 C.F.R. § 275.205-3(d). The Act also requires the SEC to adjust certain dollar thresholds for inflation, including the $750,000 and $1.5 million thresholds in the private client definition. The initial adjustment is required to be made within one year, and subsequent adjustments every five years thereafter.

42. 17 C.F.R. § 275.205-3(b).

43. *See* www.sec.gov/info/cco/requestlistcore1108.htm for the SEC's "core initial request" for examination information.

44. CRS §§ 11-51-101 *et seq*.

45. CRS § 11-51-401(1.5).

46. CRS § 11-51-402(5).

47. *Id.* Under federal laws, states are permitted to regulate only investment advisers with a place of business in the state or at least six clients in the state. 15 U.S.C. § 80b-22(d).

48. In New York, for example, private investment advisers (those with fewer than fifteen clients during any twelve-month period) were exempt from registration with the state. NY GBL § 359-eee-1(a)(7). However, because the New York exemption was structured as a cross-reference to Section 203(b)(3) of the Advisers Act, the repeal of Section 203(b)(3) also may repeal the New York exemption.

49. CRS § 11-51-401(1.6).

50. 3 C.C.R. 704-1-51-4.1(IA). *See also* www.sos.state.co.us/CCR/Welcome.do.

51. CRS § 11-51-401(2.5).

52. CRS § 11-51-201(9.6)(a).

53. In lieu of a Series 65 Exam, the applicant can complete the Series 7 and Series 66 exams. The Series 65 Exam is not required for individuals with any of seven professional financial planning designations, such as Certified Financial Planner or Chartered Financial Analyst. In addition, an applicant must pay a licensing fee and file verification of identity and lawful presence in the United States. *See* 3 C.C.R. 704-1-51-4.4(IA).

54. The federal definition of an investment adviser representative is contained in 17 C.F.R. § 275.203A-3(a)(1). *See supra* note 24 and accompanying text. ■