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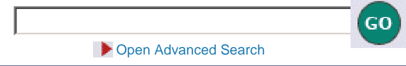

PERSONAL FINANCIAL PLANNING / PRACTICE MANAGEMENT

# New Investment Adviser Requirements of the Dodd-Frank Act: What CPAs Should Know

## More changes and clarifications to come as rulemaking commences.

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The Dodd-Frank Wall Street Reform and Consumer Protection Act, PL 111-203 (Reform Act, tinyurl.com/26zalzn), which was signed into law by President Barack Obama in July 2010, will require sweeping changes to virtually all areas of the financial services industry in the United States and will affect a wide variety of businesses and professions, including CPAs, investment advisers and financial planners. One area of particular importance to CPAs is new requirements regarding the registration of investment advisers under the Investment Advisers Act of 1940 (Advisers Act) and related matters.

This article provides an overview of the top provisions of the Reform Act relating to investment advisers and financial planners of which all CPAs should be aware (Title IV of the Reform Act), as well as other relevant provisions of the Reform Act, both for themselves and their clients. Many aspects of the Reform Act will not take effect until July 2011, and its full implications will not be known until the SEC and other regulatory agencies complete the many rulemakings, studies and reports the Reform Act requires. (A timetable of planned guidance releases and other mandated governmental actions is at tinyurl.com/2dw28df.) However, CPAs would be well-served to familiarize themselves with the following aspects of the Reform Act now, so that they may position themselves and their clients for the brave new regulatory world that is fast approaching, if not already here.

### FEDERAL VS. STATE INVESTMENT ADVISER REGISTRATION

***The eligibility threshold for SEC registration has been raised, requiring many registrants to switch to state registration.*** One of the most significant changes for CPA financial advisers wrought by the Reform Act is its new eligibility requirements for registering as an investment adviser with the SEC under the Advisers Act (federal registration) as opposed to registration with one or more state securities regulatory authorities under state law. Under the investment adviser regulatory scheme in the United States, an investment adviser registers either with the SEC or the states but not both. The Reform Act shifts to the states the regulatory responsibility for monitoring many smaller advisers so that the SEC may concentrate its examination resources on larger advisers.

Under current law, an investment adviser generally is prohibited from registering with the SEC under the Advisers Act if it has less than $25 million of assets under management (and instead must register with a state, if required by applicable state law). If, however, an investment adviser has at least $25 million but less than $30 million of assets under management, the adviser may choose to register with the SEC instead of a state. If the adviser has $30 million or more of assets under management, the adviser must register with the SEC, unless an exemption is available.

Section 410 of the Reform Act effectively raises these eligibility thresholds by prohibiting SEC registration unless the investment adviser has more than $100 million of assets under management, in which case the adviser is required to register with the SEC, unless an exemption is available. If, however, the adviser has between $25 million and $100 million of assets under management and is not subject to registration and examination by its home state, then it is required to register with the SEC, notwithstanding that it does not meet the $100 million threshold. In addition, if an adviser with between $25 million and $100 million of assets under management is otherwise required to register with 15 or more states, the adviser may elect, but is not required, to register with the SEC. The Reform Act gives the SEC the ability to raise the $100 million threshold by rule. The foregoing new eligibility requirements take effect July 21, 2011.

Therefore, SEC-registered investment advisers with more than $100 million of assets under management should not be affected by the Reform Act's reallocation of federal and state authority. The Reform Act will, however, require many SEC-registered investment advisers with assets of less than $100 million to withdraw their registrations and instead register with their


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home states and possibly other states in which their clients reside, by July 21, 2011. Given that state registration and compliance requirements may differ from the SEC's requirements and that each state's requirements may be different from other states' requirements, registration with one or more states may prove more costly and administratively burdensome than SEC registration.

CPAs with investment advisory clients should consider familiarizing themselves with these new eligibility requirements and, if necessary, reviewing with their clients the federal or applicable state investment advisory registration and compliance requirements, before the compliance date. To help investment advisers prepare to switch from federal to state registration, the North American Securities Administrators Association (NASAA), a voluntary association of state securities regulatory agencies, has launched an online resource, the NASAA IA Switch Resource Center, which is available on the NASAA's website at tinyurl.com/2cm9qqk. The site includes background information, answers to frequently asked questions, and a directory of state contacts. In addition, for more information regarding federal versus state registration eligibility requirements under current law as well as under the Reform Act, see Exhibit 1.

## POSSIBLE FIDUCIARY DUTY FOR BROKER-DEALERS

***Following a study, the SEC is authorized to establish a fiduciary duty for broker- dealers, similar to investment advisers.*** Currently, broker-dealers are subject to a suitability standard when giving incidental investment advice to their customers. Investment advisers are held to a fiduciary duty standard when giving investment advice to their clients. One area of debate within the financial services industry is whether the different legal duties and standards of care should be made uniform for broker-dealers with those of investment advisers when giving incidental investment advice to their customers and clients. Section 913 of the Reform Act requires the SEC to conduct a study to evaluate the effectiveness of existing standards of care for broker-dealers, investment advisers and their associated persons when providing personalized investment advice about securities to retail customers, and authorizes the SEC to promulgate rules imposing a fiduciary duty standard on broker-dealers who provide personalized investment advice to retail customers. The SEC is required to issue its report to Congress by this month. Requiring retail broker-dealers to comply with a fiduciary duty standard may result in significant changes to many retail broker-dealers' business models.

Members of CPA firms that audit broker-dealers should be aware that the Reform Act also provides for the PCAOB to create a program for registering and inspecting public accounting firms that audit nonpublic broker-dealers. It further allows the PCAOB to differentiate among classes of broker-dealers, as appropriate.

## WHO IS AN INVESTMENT ADVISER?

***The "solely incidental" exclusion for accountants and other professionals remains.*** Section 202(a) of the Advisers Act defines the term "investment adviser" broadly to include any person who, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities. However, various persons and activities are excluded from this definition, which means that persons performing these activities are not required to register as investment advisers. In particular, "any lawyer, accountant, engineer or teacher whose performance of such services is solely incidental to the practice of his profession" is excluded from the definition of investment adviser (Advisers Act, section 202(a)(11)(B)).

This exclusion for accountants and other professional services providers remains unchanged by the Reform Act. It should be noted, however, that the SEC has interpreted this exclusion narrowly. For example, investment advice must be in connection with the provision of the professional's services and cannot be provided as a separate line of services. Importantly, a CPA or CPA firm that "holds itself out" as a financial planner or financial adviser or as providing financial planning or advice cannot use the solely incidental exclusion (SEC Release IA-1092). CPAs should review the scope and content of their services to confirm that they continue to qualify for the exclusion, to the extent applicable.

***CPAs are exempted from oversight by the new Bureau of Consumer Financial Protection.*** One of the more controversial aspects of the Reform Act is Title X, which creates a new Bureau of Consumer Financial Protection. The bureau's mandate will be to coordinate, implement and enforce federal consumer law for the purpose of ensuring fair, transparent and competitive markets for consumer financial products. In a provision that was aggressively supported by the AICPA, the Reform Act generally exempts CPAs from regulation by the bureau. Importantly, the exemption applies only to the extent that a CPA engages in activities that are "customary and usual," such as accounting, financial planning and tax services. Extending credit will not be deemed a customary and usual activity. Broker-dealers and investment advisers, because they are regulated by the SEC, are also exempt, but other financial planners are not exempt from bureau regulation.

CPAs will need to analyze whether they qualify for the exemption, given the nature of their services, in light of this new regulatory framework, the forthcoming implementing regulations and any additional exemptive relief that may be granted.

## FAMILY OFFICES

***Family offices will not be required to register as investment advisers.*** Another area of some uncertainty is whether a "family office"—that is, an entity established by a wealthy family and devoted to managing its investments and business affairs—is subject to registration as an investment adviser under the Advisers Act. Historically, many family offices have avoided registration under the Advisers Act by taking the position they were outside the definition of the term "investment adviser," or else by relying on the "private adviser" exemption from registration, while others have registered as investment advisers. As discussed below, the Reform Act repealed the private adviser exemption, which means that family offices may no longer rely on it. Instead, the Reform Act addressed the registration of family offices more specifically than in the past. Indeed, the term "family office" did not appear in the Advisers Act before the Reform Act,

and the SEC has in the past issued only limited exemptive relief regarding the applicability to family offices of Advisers Act registration requirements. In light of this limited guidance, and given that family offices take many forms, many family office operations have struggled to apply the registration requirements of the Advisers Act to their situations.

Section 409 of the Reform Act attempts to remove this uncertainty by amending the Advisers Act to provide an exclusion from the definition of investment adviser for any adviser that is a family

office. The term "family office" is to be defined by the SEC in a manner consistent with the SEC's previous exemptive relief and taking into account the range of organization, management and employment structures and arrangements employed by family offices.

On Oct. 12, the SEC proposed a new rule that would define a family office generally as any firm that: (a) provides investment advice only to family members as defined by the proposed rule, certain key employees, charities and trusts established by family members, and entities wholly owned and controlled by family members; (b) is wholly owned and controlled by family members; and (c) does not hold itself out to the public as an investment adviser. Public comments on the proposed rule were due by Nov. 18. Comments by the AICPA suggest clarifying several definitions, such as that for "family members" and the "founder" of a family office from whom the family members trace their relationship. They may be read at tinyurl.com/25moy6y. The Reform Act also provides a grandfathering exemption for persons already providing investment advice to family offices under certain narrow conditions specified in the Reform Act. CPAs with family offices as clients, as well as CPAs acting as family offices, will need to familiarize themselves with the SEC's new definition once it becomes final.

## PRIVATE FUNDS AND PRIVATE ADVISER EXEMPTION

***Most advisers to hedge and private equity funds will be required to register, while advisers to venture capital funds will not. New reports regarding private funds will be required.***

Another area of the Reform Act that has received much attention is the provision that requires most managers of "private funds" to register as investment advisers (section 403 of the Reform Act). The term "private fund" is defined in the Reform Act to encompass virtually any privately offered pooled investment fund, such as hedge funds and private equity funds. However, section 407 of the Reform Act provides that a private fund manager that provides advice solely to one or more venture capital funds is exempt from having to register as an investment adviser. The term "venture capital fund" is not defined in the Reform Act but instead is to be defined by the SEC by July 2011. It will be interesting to see how the SEC differentiates venture capital funds from private equity funds and other funds.

The Reform Act accomplishes this sweeping change by eliminating the exemption relied on by many private fund managers—the "private adviser" exemption—effective July 21, 2011. The private adviser exemption currently exempts from registration any investment adviser that has had fewer than 15 clients in the past 12 months and neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to a registered investment company. It should be noted that the Reform Act eliminates the private adviser exemption for all advisers, not just private fund advisers. The Reform Act replaces the private adviser exemption with several, more limited exemptions, such as the exemption for family offices noted above, an exemption for "foreign private advisers" and an exemption for persons acting solely as advisers to private funds and that have less than $150 million in aggregate assets under management.

A registered private fund adviser will be subject to additional reporting, recordkeeping and disclosure requirements. Section 404 of the Reform Act provides the SEC with broad authority to require registered advisers to maintain records, undergo examinations and provide reports to the SEC and the Financial Stability Oversight Council, the new federal systemic risk regulator created by the Reform Act "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk." The SEC also will have the authority to require certain investment advisers that are not registered, such as venture capital fund advisers, to file reports. The SEC also will be authorized to tailor its reporting and recordkeeping requirements to different sizes and types of investment advisers (including "midsized private fund advisers"—a term not explicitly defined in the Reform Act).

Investment advisers to private funds should familiarize themselves with these new requirements. Private fund advisers will need to consider whether they will be required to register as investment advisers pursuant to the Reform Act and, if so, begin taking steps to comply with the registration and ongoing compliance requirements of the Advisers Act. In this regard, the Reform Act's registration requirement raises a number of interesting interpretive questions, such as whether an adviser to a private equity fund that is no longer making investments and instead is in wind-down or harvesting mode is nonetheless required to register.

## PRIVATE OFFERINGS OF SECURITIES, PERFORMANCE FEE ARRANGEMENTS

***Certain client suitability standards will be reviewed periodically and adjusted for inflation.***

Section 413 of the Reform Act makes several changes to the "accredited investor" definition in Regulation D of the Securities Act of 1933 in connection with private offerings of securities, which has not been adjusted for inflation since its passage several decades ago. In particular, the Reform Act adjusts, effective immediately, the accredited investor net worth standard for natural persons (currently more than $1 million individually or jointly with a spouse) to exclude the value of the person's primary residence. In addition, the SEC is required to review and make any modifications it deems necessary to the net worth standard for individuals every four years. Section 418 of the Reform Act also requires the SEC, by July 2011 and every five years thereafter, to adjust for inflation the "qualified client" standard in Advisers Act Rule 205-3. Section 205 of the Advisers Act prohibits registered investment advisers from charging clients or investors performance-based fees, unless the client or investor is a "qualified client," as defined. Accordingly, investment advisers may need to amend their offering memoranda and advisory agreements to reflect the foregoing changes as they occur.

## POSSIBLE NEW RULES FOR ADVISERS

***The SEC's oversight and examinations of registered investment advisers may change.*** Section 914 of the Reform Act requires the SEC to review and analyze the need for enhanced examination and enforcement resources for investment advisers, including dually registered investment advisers and broker-dealers, or investment advisers who are affiliated with broker-dealers. Further, the SEC is directed to consider whether Congress should authorize the SEC to designate one or more self-regulatory organizations (SROs), such as the Financial Industry Regulatory Authority, the self-regulatory organization for broker-dealers, or perhaps a new organization altogether, to augment the SEC's efforts in overseeing investment advisers. The SEC must submit a report on the foregoing matters to Congress by this month. Section 416 of the Reform Act also requires the Government Accountability Office (GAO) to submit a report to Congress by July 2011 regarding the feasibility of forming an SRO to oversee private funds specifically.

***Additional custody rules could be forthcoming.*** Section 411 of the Reform Act amends the Advisers Act by specifically requiring registered investment advisers to "take such steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the [SEC] may, by rule, prescribe." The SEC's existing custody rule, Advisers Act Rule 206(4)-2, imposes various requirements on registered investment advisers that have custody of client funds or securities, including requiring advisers to maintain client assets with a qualified custodian, and requiring advisers with custody to undergo an annual surprise examination by an independent public accountant to verify client assets, unless an exemption applies. Accordingly, the Reform Act appears to do little more than reiterate the obligations of advisers regarding custody of client assets and the SEC's authority to promulgate rules regarding the same (no doubt a sensitive topic in Congress in the wake of the Madoff Ponzi scheme). Section 412 of the Reform Act also requires the GAO to conduct a study of the compliance costs of the custody rule by July 2013. However, CPAs may wish to monitor new SEC rulemaking in this area to position themselves to provide new auditing or other services to their investment adviser clients so that their clients may comply with any new custody requirements. In addition, whether or not new requirements are imposed, the custody rule is sure to present interesting compliance issues for advisory firms and their professional advisers, given the number and variety of advisory firms that for the first time will be required to register as investment advisers under the Reform Act.

## WHAT IS "INVESTMENT ADVICE"?

***Financial planners may be subject to new regulations.*** While there is no definition of "financial planning" in the Advisers Act, financial planning may encompass a wide variety of services, some of which may be deemed to be "investment advice" subjecting practitioners to regulation. Specifically, where financial planning services involve advice regarding securities, including allocations among securities and other investments, the Advisers Act likely will apply, and the financial planner will be required to register as an investment adviser, absent an exemption. The number of persons providing financial planning services and the complexity and variety of those services have grown enormously in recent years.

To address uncertainties regarding the status of financial planners under the Advisers Act and other laws and to improve the regulatory oversight of financial planners generally, section 919C of the Reform Act requires the GAO to conduct a study to evaluate the current framework of federal and state laws and regulations that apply to financial planners and consider whether different or additional laws, regulations and regulatory oversight are warranted to protect the public. The GAO is required to submit a report with findings and recommendations to Congress by this month. Depending on the outcome of any regulatory or legislative initiatives in response to the report, financial planners—regardless of whether they are already registered as investment advisers—may become subject to new requirements, including minimum competency standards, ethical guidelines, disciplinary oversight and disclosure requirements, under the Advisers Act or under other existing or new federal or state laws. CPAs with financial planners as clients, as well as accountants providing financial planning services, should monitor legislative or regulatory developments in this area.

## UNKNOWNS IN THE ROAD AHEAD

Taken as a whole, the Reform Act represents a significant change to the existing system of financial services regulation in the United States, not only for investment advisers but for virtually any business or profession in, or related to, the financial services industry. While the passage of the Reform Act clarifies the regulatory road map for investment advisers going forward after several years of legislative uncertainty, many unknowns remain, at least until the SEC and other regulatory agencies complete their rulemaking, which as of this writing, is under way. Even after such rulemaking, given the scope and complexity of the Reform Act and the wide variety of businesses affected, important interpretive questions will likely remain unanswered. Against this challenging regulatory and business environment, it is imperative for investment firms and financial planners to obtain competent counsel from their professional advisers, and for CPAs and accountants to stay abreast of new developments as they occur.

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## EXECUTIVE SUMMARY

- **Among the changes the Dodd-Frank Wall Street Reform and Consumer Protection Act,** PL 111-203, (Reform Act) brings are laws affecting CPA financial advisers. These laws will be implemented by various regulations that the SEC will write in the coming months. CPA advisers should monitor the SEC's rulemaking activities and assess the impact of these laws and regulations on their practices. Chief among such provisions is the shifting of registration of many registered investment advisers from the SEC to the states.

- **While the details await the results of a study,** the SEC may establish a fiduciary duty for

broker-dealers similar to that for investment advisers.

■ **CPAs who have relied upon the exclusion from registration for services** "solely incidental" to accountancy may continue to do so, and "family offices" generally are not required to register as investment advisers. Also, CPAs generally are exempted from oversight by the Bureau of Consumer Financial Protection established by the Reform Act.

■ **Advisers to venture capital funds** likewise are not required to register, but most advisers to private equity and hedge funds will be. The definition of "accredited investor" for purposes of private offerings of securities has been revised and will be updated periodically.

■ **The SEC will examine whether investment advisers** should be subject to additional oversight by an existing or new organization. Regulations on broader financial planning services offered by CPAs could result from a study the Reform Act directs the Government Accountability Office to conduct.



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## AICPA RESOURCES

### Publications

- *The New Fiduciary Standard: The 27 Prudent Investment Practices for Financial Advisers, Trustees, and Plan Sponsors* (#017242)
- *Accountant's Business Manual* (#029418) or online reference (#ABM-XX)

### Conferences

- AICPA Advanced Personal Financial Planning Conference, Jan. 10–12, Las Vegas
- AICPA National Advanced Accounting and Auditing Technical Symposium, July 14–15, Las Vegas
- AICPA Controllers Workshop West, July 28–29, Las Vegas
- AICPA Controllers Workshop East, Nov. 10–11, Orlando, Fla.

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### White paper

The AICPA has prepared a white paper on what financial reform means to CPAs, tinyurl.com/38t6m2d

### Webinar

"The Dodd-Frank Wall Street Reform and Consumer Protection Act: What CPA Financial Planners Need to Know," presented by Wesley G. Nissen, Aug. 12, 2010, tinyurl.com/2ffsxwh

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