Dodd-Frank Act changes the rules for many investment fund managers

"The alleged scandal at Madoff Investment Securities has reminded us yet again of how badly reform is needed when it comes to the rules and regulations that govern our markets." *President-elect Barack Obama, Dec. 18, 2008.*

Nineteen months later, the president signed into law the Private Fund Investment Advisers Act of 2010 as part of the 2,319-page Dodd-Frank Act. Never mind that Bernie Madoff's firm already was registered with the U.S. Securities and Exchange Commission and subject to its oversight, and that he didn't manage private investment funds. The law fundamentally changes the regulatory landscape for private fund managers, and with much less fanfare, it also dramatically enlarges the role of states in regulating investment advisers.

North Carolina is home to a number of private equity, venture capital, hedge and other types of private investment fund managers. Managers have always been required to comply with anti-fraud rules and other securities laws established for investor protection. But until now, most private fund managers have not themselves had to register with the SEC or with comparable state authorities. The Dodd-Frank Act changes all that.

"The question for many fund managers is not *whether* they have to register but *where*."

Goodbye, private adviser exemption

Until Dodd-Frank, the Investment Advisers Act of 1940 contained an exemption from registration for investment advisers with fewer than 15 "clients" – often referred to as the "private adviser exemption." Because a fund manager is generally deemed to advise the funds it manages (as opposed to the funds' investors), fund managers could use this exemption if they managed fewer than 15 funds. Most states, including North Carolina, have exempted advisers that are exempt from federal registration under this private adviser exemption.

The Dodd-Frank Act eliminated this exemption, effective July 21, 2011, and in so doing also effectively eliminated the corresponding exemption in most states. As a result, the vast majority of private fund managers will now be required to register with either the SEC or one or more state securities authorities. (At the time this article was submitted, the SEC had indicated it expects to extend the July 21 deadline.)

Hello, state regulators

Perhaps recognizing that requiring the registration of private fund advisers would lead to a flood of SEC registrations, Congress made other changes that will result in many advisers registering with state authorities instead. The Advisers Act has long *prohibited* firms from registering with the SEC unless they manage at least $25 million in assets. Dodd-Frank raises that threshold to $100 million, unless the adviser is not required to register or is not subject to examination as an investment adviser in its home state (in which case federal registration is required), or the adviser would be required to register in fifteen or more states. North Carolina requires registration and subjects registrants to examination. The SEC has estimated that, across the country, this change will result in as many as 4,000 investment advisers currently registered with the SEC *de-registering* and then registering with state authorities.

Meanwhile, Dodd-Frank added exemptions from registration for advisers to venture capital funds, advisers to small business investment companies, advisers to private investment funds with less than $150 million in assets and foreign advisers with limited activities and funds under management in the United States. These exemptions have attracted a lot of attention, but because the states do not have corresponding exemptions, their effect may simply be to make those types of advisers choose between federal and state registration.

What about North Carolina?

For federally exempt fund managers in North Carolina, the result of Dodd-Frank is unclear. This is because North Carolina's private adviser exemption states that it is available to an adviser that "is exempt from registration" under the federal private adviser exemption "as it existed on June 1, 1988." Is it enough that an adviser *would have been exempt* under the federal exemption as it existed on June 1, 1988, or does the language "is exempt" require that the adviser continue to be exempt under this exemption, which no longer exists? If the former, fund managers with fewer than 15 clients who can use one of the new federal exemptions will also be exempt from North Carolina registration. If the latter, most fund managers in North Carolina will be required to register with either the SEC or the N.C. Secretary of State.

Not whether, but where — and who?

Putting aside the question of how the state's private adviser exemption will be construed, the question for many private fund managers is not *whether* they will be required to register as an investment adviser but *where*. A key difference between federal and state registration is that most states also require the registration of those employees of the adviser who solicit clients or provide advice. North Carolina requires that such individuals not only register, but also pass certain securities exams or maintain one of several professional designations.

Federal registration may be more onerous in other respects, including the rigor with which the SEC may examine federally registered advisers in a post-Madoff era. For fund advisers with the choice, decisions may vary. Fund managers that will have this choice include those managing between $100 million and $150 million and those with over $150 million under management that are eligible for the venture capital or SBIC exemption.

Other implications for fund managers

Upon registering, fund managers have to designate a chief compliance officer, adopt compliance policies, comply with ongoing requirements for reporting and recordkeeping and custody of client assets among other requirements. While many of these represent best practices, they will require time and will likely raise the cost of doing business.

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These requirements may make it more difficult for emerging managers, first-time fund managers and small venture capital firms to operate profitably. The burden is such that many foreign fund managers are engaging in efforts to avoid investment adviser regulation by the U.S., including by declining to accept U.S. investors.

Perhaps for these reasons, some in Congress are already asking to revisit the registration requirement. But regardless of what Washington does, one aspect of Dodd-Frank that has escaped much attention is the increased burden on state regulators. Do they have the resources to fulfill their new responsibilities? Do they welcome the regulatory shift from the SEC? Equally overlooked has been the fact that the exemption for advisers to venture capital funds may be of only marginal benefit due to state registration requirements. With North Carolina's history of promoting entrepreneurship, will our General Assembly move to solidify our venture-friendly atmosphere by enacting a corresponding exemption? Will other states?