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The Impact of the Dodd-Frank Act on Registered Investment Companies

I. Introduction

The core provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") for the most part focus on areas of the financial services industry other than the registered fund sector. However, the Dodd-Frank Act's sweeping expansion of federal regulation in the financial sector will affect investment companies and the investment management industry as a whole, generally in indirect and often subtle ways. Moreover, many of the more controversial issues under consideration during the legislative process were left to be resolved by regulatory studies and rulemakings, and in some cases further remedial legislation, deferring their resolution to a future date.

The Dodd-Frank Act will restructure the U.S. financial system by providing widespread regulation of financial institutions (primarily through a broad new regulatory framework designed to protect the financial system from systemic risk), consumer financial products and services, broker-dealers, over-the-counter ("OTC") derivatives, investment advisers, credit rating agencies and mortgage lending. Of note is the extent to which the Dodd-Frank Act is silent regarding mutual fund[1] regulation, other than in the areas of sales practices and investor protection. Nevertheless, because of the overarching influence of the SEC on mutual funds and their management, the Dodd-Frank Act's restructuring of the regulatory landscape and its impact on the SEC's management and agenda have the potential to change how the fund industry is regulated. The enactment of the Dodd-Frank Act itself is merely the opening curtain to the first act in a new regulatory era affecting all aspects of financial services and products. Some of the more significant areas broadly affected by the Dodd-Frank Act include those discussed below.

II. General Provisions of the Dodd-Frank Act Impacting the Mutual Fund Industry

A. Regulatory Reform Focus on Systemically Significant Financial Institutions

The Dodd-Frank Act establishes an interagency council called the Financial Stability Oversight Council (the "Council")[2] that is designed to "identify risks to the financial stability of the U.S.," "promote market discipline" and "respond to emerging threats to the stability of the U.S. financial system." Under the Dodd-Frank Act, both bank holding companies and nonbank financial companies, which are companies that are "predominately engaged in financial activities," may fall under the supervision of the Council. The Council may consider the activity of a pooled investment vehicle, such as a registered investment company, or that of its manager, to fall under the scope of this regulation.

Board Supervision and Prudential Standards. If the Council concludes that the "material financial distress" at a nonbank financial company or the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of a nonbank financial company could pose a threat to the financial stability of the U.S., the company can be required to (i) be supervised by the Federal Reserve Board of Governors (the "Board") and (ii) be subject to prudential standards. Whether major fund complexes and their advisers may be deemed systemically important remains unclear. Among the factors that the Council must take into consideration, there are several that may reduce the probability that investment companies could fall under the supervision of the Board, such as:

- the extent of the leverage of the company;
- the extent to which assets are managed rather than owned by the company;
- the extent to which ownership of assets under management is diffuse; and
- the degree to which the company is already regulated by one or more primary financial regulatory agencies.[3]

While the second, third and fourth factors appear to weigh against deeming a fund complex or its manager to be systemically significant (and indeed were prompted in part by the arguments of the investment company industry), it is possible that the Council could have systemic concerns about large fund complexes and their managers. If a company does fall under the supervision of the Board, the Board can implement stringent prudential standards and reporting and disclosure requirements on the targeted entity. The prudential standards can include the following:

- risk-based capital requirements and leverage limits, unless the Board determines that such requirements are not appropriate for a company subject to more stringent prudential standards because of the activities of such company (such as investment company activities) or structure, in which case, the Board shall apply other standards that result in similarly stringent risk controls; and
- liquidity requirements; overall risk management requirements; resolution plan and credit exposure report requirements; concentration limits; a contingent capital requirement; enhanced public disclosures; short-term debt limits; and such other prudential standards deemed appropriate.[4]

It seems unlikely that capital requirements would apply to investment companies. While the prudential requirements may have more applicability, the standards are clearly oriented towards the regulation of banks, and unless modified, could impede the normal operations of investment companies and their managers.

B. Investor Protection Provisions

The much-publicized Bureau of Consumer Financial Protection created by the Dodd-Frank Act does not have jurisdiction over mutual funds. However, the Dodd-Frank Act establishes within the SEC a new Investor Advisory Committee, created to advise and consult with the SEC on investor protection, the effectiveness of disclosure and other issues. Several other provisions of the Dodd-Frank Act are designed to address general concerns related to investor protection as well as the general functioning of the SEC – including hiring market specialists, sharing information with other agencies, paying compensation to victims, investor testing, and self-examination – and require reports to Congress, including a report by an independent consultant on the internal operations, structure and funding of the SEC.

The investor protection provisions of the Dodd-Frank Act will also have a major impact on the SEC's enforcement agenda. Whistleblowers are being encouraged through potentially lucrative bounties to report suspect activities, and the SEC will benefit from relaxed evidentiary standards of proof in pursuing secondary actors, expanded jurisdiction over activities conducted abroad, the ability to obtain penalty awards in SEC administrative cases, industry-wide bars for securities professionals, and the ability to subpoena trial witnesses nationally. The Dodd-Frank Act also provides for the SEC to impose aiding and abetting liability on persons who "recklessly" provide substantial assistance to someone who violates the antifraud and other provisions of the Securities

Exchange Act of 1934 (the "Exchange Act"), and it provides for aiding and abetting liability under the Securities Act of 1933, the Company Act and the Investment Advisers Act of 1940 (the "Advisers Act"). The Dodd-Frank Act also permits the SEC to seek civil penalties for aiding and abetting cases under the Advisers Act and for administrative cease and desist proceedings, and it clarifies that the SEC may pursue enforcement actions against so-called "control" persons (those found to "directly or indirectly control" a violator) unless they acted in "good faith" and did not "directly or indirectly induce" the violative conduct.

In addition, the Dodd-Frank Act permits the SEC to bring enforcement actions for breach of fiduciary duty against "a person who is, or at the time of the alleged misconduct was, serving or acting" for an investment company. Such persons or entities include former directors, officers, investment advisers, depositors or principal underwriters or members of an advisory board. Together with a newly reorganized enforcement division, increased staffing and "get-tough" statements of senior staff officials, regulation through enforcement can be expected to have a significant impact on the investment company industry. For more information, please see Investor Protection Provisions of Dodd-Frank.

C. Changes to the Competitive Landscape; Private Fund Adviser Registration

It also is to be expected that the new private fund adviser registration requirements and the significantly more robust recordkeeping, reporting and examination requirements to which private fund advisers will be subject will narrow the gap between the business and regulatory environments in which non-registered advisers to private funds and registered advisers to mutual funds have operated. From the perspective of many investors, the comparative advantages of an investment in a private fund and a mutual fund employing the same investment strategy may merit re-examination.[5] An investment in a private fund could now appear to be less risky at the same time as the fund may be subject to higher compliance costs. Moreover, once registered, private fund advisers might more readily consider sponsoring and managing mutual funds.

In addition, under the so-called "Volcker Rule,"[6] banking entities will be generally prohibited from acquiring or retaining any meaningful ownership interest in or sponsoring a hedge fund or private equity fund. This could further change the competitive landscape.

III. Specific Provisions of the Dodd-Frank Act Affecting the Mutual Fund Industry

A. Changes Affecting the Distribution of Mutual Fund Shares

The Dodd-Frank Act empowered the SEC to consider whether to impose fiduciary duties on broker-dealers that charge asset-based fees for providing advice to retail clients. Rather than resolving the issue itself by enacting one of the fiduciary standard provisions included in the House or Senate bills, the Dodd-Frank Act requires the SEC to conduct a study evaluating the standards of care for broker-dealers and investment advisers and comparing the relative regulatory standards for broker-dealers with those for investment advisers. Congress placed a heavy hand on the scale by detailing the issues to be considered by the SEC in the process, requiring the SEC to seek and consider public input and directing the SEC to submit a report – within six months of the Dodd-Frank Act's passage – covering specific areas, including whether there are regulatory gaps or areas of regulatory overlap in the protection of retail customers relating to the standards of care for broker-dealers and investment advisers providing personalized investment advice about securities.

Thereafter, the SEC is authorized to commence a rulemaking to address these standards of care and is given specific detailed authority to establish a fiduciary duty for brokers and dealers. Significantly, the Dodd-Frank Act affirmatively states that there would be no continuing duty of care or loyalty to a customer of a broker or dealer after providing personalized investment advice about securities. How any such duty will specifically impact brokers selling mutual funds, particularly proprietary products, depends on the debate before the SEC and the ultimate terms of the rule adopted.[7]

B. Disclosures and Advertising Practices

Other rulemakings and studies, required of the SEC over the course of the next several years, number in the hundreds and in many cases involve controversial issues that can be expected to promote heated debate. Many focus on investor protection; among the more important to the public fund industry is the *Study Regarding Financial Literacy Among Investors*, in which the SEC is to explore the level of financial literacy among retail investors, particularly with regard to the purchase of mutual fund shares. To be completed within two years, the study will include particular focus on the timing, content and format of disclosures, as well as identification of the most useful and understandable relevant information that retail investors need to make informed financial decisions about mutual funds, with particular attention to transparency of expenses and conflicts of interest.

In a separate study, the *Study Regarding Mutual Fund Advertising*, the Government Accountability Office ("GAO") is charged, subject to a one-year time deadline, with reviewing and recommending improvements to mutual fund advertising, in order to improve investor protection and ensure informed financial decisions by retail investors purchasing mutual fund shares.

Without calling for a specific study, the provisions for *Clarification of Commission Authority to Require Investor Disclosures Before Purchase of Investment Products and Services* authorizes the SEC to issue point-of-sale disclosure rules for brokers or dealers to provide basic information to retail investors before the purchase of an investment product or service.

The SEC has already begun to tackle these various statutorily mandated studies and rulemakings by requesting public comment; in doing so, Chairman Schapiro has announced administrative modifications to the SEC's rulemaking process, including permitting the receipt of comments prior to a Release being issued, a higher degree of disclosures of meetings with SEC staffers and a willingness to call for public hearings on particular issues. Additional changes to the process can be expected as a result of heightened congressional oversight over the rulemaking process as well as the expectation for follow-on legislation addressing any number of areas. It is worth noting that the SEC is expected to hire more than 800 new employees as a result of the increased funding facilitated by the Dodd-Frank Act.

C. Reliance on Credit Rating Agencies

The Dodd-Frank Act establishes an almost wholly new framework for governing and regulating credit rating agencies, including nationally recognized statistical rating organizations ("NRSROs"). The overhaul stands to dramatically change the role NRSROs play in the markets, and it could have a significant impact on the mutual fund industry. In particular, the Dodd-Frank Act grants increased authority to the SEC through the establishment of an Office of Credit Ratings (the "OCR") within the SEC; and a requirement for federal agencies to remove references to NRSROs from their rules, provided there are reasonable alternatives. In addition, the Dodd-Frank Act imposes new requirements covering key areas of NRSRO function and oversight, including:

- lowering pleading requirements, removing safe-harbor protections, and imposing filing and other requirements, which heighten the liability that NRSROs face;
- minimizing the impact of conflicts of interest on the integrity of NRSROs' issuance of credit ratings;
- requiring disclosure by NRSROs of an array of new information, such as the performance record of their credit ratings and the procedures and methodologies used in the credit ratings process;
- calling for the SEC and other federal agencies to develop new standards of creditworthiness;
- mandating provisions designed to improve the asset-backed securitization process, including new disclosure requirements and an SEC study to identify the appropriate way to reconstruct the current issuer-pays business model of obtaining credit ratings for asset-backed securities; and
- directing the SEC, the GAO and others to conduct studies that may result in additional rules and regulations affecting the role and

import of NRSROs and credit ratings in the markets.

These changes may especially impact money market funds (which otherwise are not covered directly by the Dodd-Frank Act, perhaps in deference to the SEC's recent rulemakings tightening standards for these funds) and their boards in reaching judgments regarding the creditworthiness of issuers. For more information, please see Financial Reform Bill Strengthens Regulation, Expands Potential Liability of Credit Rating Agencies.

D. Regulation of Derivatives

The Dodd-Frank Act completely overhauls the regulation of the OTC derivatives market in the United States. The primary objectives of the Dodd-Frank Act in the derivatives arena are to bring about greater transparency and to enable regulators to better manage individual counterparty and broader systemic risks that are inherent in the OTC derivatives market. In general, the increased transparency and efficiency resulting from these changes should benefit fund managers and facilitate board oversight of derivatives. The principal changes effected by the Dodd-Frank Act include:

- Imposing substantial requirements on the most active OTC derivatives market participants, major swap participants and swap dealers, including reporting, capital and margin requirements;
- Subjecting many derivatives that are currently traded OTC to central clearing and exchange trading in regulated trading systems; and
- Establishing more clearly the jurisdiction of the key regulators of derivatives, the SEC and the Commodity Futures Trading Commission, and repealing exemptions and exclusions that stood in the way of their regulation of the multi-trillion dollar OTC market.

These changes have the potential to significantly change the economics of engaging in hedging transactions and could impact investment strategies in the short and long term.

E. Regulation of Short Sales

The Dodd-Frank Act places additional regulation on short selling of securities by amending the Exchange Act to prohibit any "manipulative short sale of any security" and to authorize the SEC to issue rules to enforce this provision. The SEC must issue rules providing for public disclosure at least monthly of short sale activity in each security. Brokers must notify customers that they may elect not to allow their securities to be used in connection with short sales, and brokers must disclose that they may receive compensation for lending their customers' securities. The SEC may by rule specify the "form, content, time, and manner of delivery" of such customer notifications.

F. Securities Lending

The Dodd-Frank Act requires the SEC, within two years, to promulgate rules designed to increase the transparency of information available with respect to the lending or borrowing of securities. In addition, the Dodd-Frank Act amends the Exchange Act to make it unlawful to lend or borrow securities in contravention of the new SEC rules. Once effective, these rules should benefit independent directors in discharging their obligations to oversee securities lending.

G. Fund Board Oversight and Governance

The Dodd-Frank Act also provides for several regulations regarding the corporate governance structure of companies, which may impact investment funds. First, the SEC must establish rules to direct national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not have an independent compensation committee. Although open-end mutual funds are excluded from this requirement, closed-end funds are not. In addition, the SEC may issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors; such "proxy access" rules might also cover registered funds. For more information, please see New Executive Compensation and Governance Requirements in Financial Reform Legislation.

Other measures in the Dodd-Frank Act include expanding Sarbanes-Oxley provisions related to non-U.S. public accounting firms, thereby extending to OTC securities existing prohibitions on market manipulation of listed securities. The Dodd-Frank Act includes various other important investor protections and regulatory initiatives, which deal with, among other things, studying reform of self-regulatory organizations, the broker-dealer dispute arbitration process, the asset-backed securitization process, corporate accountability and executive compensation, and municipal securities. For more information, please visit our [Financial Services Reform Newsstand](). These mandates may add to the oversight responsibilities of the boards of registered investment companies.

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IV. Conclusion

As the regulators adjust to the new authorities and obligations granted by the Dodd-Frank Act, the true impact on the fund industry will begin to unfold. Now is the time for all industry participants to assess the potential effect of the Dodd-Frank Act on their individual business models and contribute to the dialogue with the SEC and Congress in a way that will assure the most thoughtful and appropriate regulatory outcomes. Although relatively few provisions of the Dodd-Frank Act are directed at the registered fund industry, its potential impact on this industry could ultimately be of great significance.

This client alert is part of a series of alerts focused on monitoring financial regulatory reform.

[1] Although the term "mutual fund" is not defined in the Investment Company Act of 1940, as amended (the "Company Act"), it is commonly used to refer to "open-end investment companies" that are registered thereunder.

[2] The Council, created by the Dodd-Frank Act, is an inter-agency body charged with identifying and monitoring systemic risks to the financial markets, including those posed by U.S. and non-U.S. "nonbank financial companies." The Council is composed of ten voting members, nine of which are granted a seat *ex officio* and one independent member appointed directly by the President. The *ex officio* members include, among others, the Secretary of the Treasury (who serves as chairperson of the Council), the Chairman of the Federal Reserve, the Comptroller of the Currency, the Director of the Bureau of Consumer Financial Protection created under the Dodd-Frank Act, the Chairperson of the SEC, the Chairperson of the CFTC, the Chairperson of the Federal Deposit Insurance Corporation and other high ranking officials from various governmental and regulatory authorities. The Dodd-Frank Act provides that the Council shall have certain non-voting members serving in an advisory capacity, including a state banking supervisor, a state insurance commissioner and a state securities commissioner.

[3] Additional factors that the Council will consider include off-balance-sheet exposures of the company; importance of the company as a source of credit; nature of the activities of the company; nature of the financial assets of the company; nature of the liabilities of the company; and other risks.

[4] The Board has several other powers that may impact investment companies and their managers. For example, if the Board deems it appropriate, it may: (i) limit the ability of a company to merge with, acquire, consolidate with, or otherwise become affiliated with another company; (ii) restrict the ability of a company to offer a financial product; (iii) terminate one or more activities; (iv) impose conditions on the company's conduct; or (v) require the company to sell or transfer assets or off-balance-sheet items to unaffiliated entities.

[5] It must be recognized that under the Company Act it is not possible for all investment strategies to be employed by a manager of a registered investment company, *e.g.*, strategies that are highly dependent on the use of leverage and the use of derivatives. However, this is not necessarily the case for managers of more conservative strategies.

[6] Section 619 of the Dodd-Frank Act. Early efforts by former Federal Reserve Chairman Paul Volcker to address concerns over the so-called "shadow banking system," which might have impacted money market funds in particular, were scaled back significantly during the legislative process.

[7] Although developed independently of the requirements of the Dodd-Frank Act, the SEC's recent rulemaking proposal to rescind Rule 12b-1 under the Company Act in favor of a new Rule 12b-2, with conforming proposals to broaden Section 22(d) of the Company Act, has the potential to dramatically alter how mutual funds are distributed. By unbundling distribution financing from fund management, and removing the process by which fund boards have been required to review and approve 12b-1 plans, the rule proposals, if adopted, will fundamentally affect fund share class structures and distribution platforms. For more information, please see SEC Proposes Reform of Rule 12b-1, Mutual Fund Distribution Payment Framework.