

# **The Dodd-Frank Wall Street Reform and Consumer Protection Act: An Analysis**

**Written by:**

**Robert Bloink, Esq., LL.M**  
Professor of Law, Graduate Program of International Tax  
and Financial Services, Thomas Jefferson School of Law

**Professor William H. Byrnes, Esq., LL.M, CWM, Fellow**  
Associate Dean, Thomas Jefferson School of Law  
Leader, Summit Business Media's Financial Advisory  
Publications

**Brought to you by:**



**a product of the National Underwriter Company/  
Summit Business Media**  
5081 Olymic Blvd  
Erlanger, KY 41018  
800-543-0874

## The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Wall Street Reform Act), signed into law by President Obama on July 21, 2010, was developed as a comprehensive response to the financial crisis of 2007-2010. President Obama summarized its purpose shortly after signing, saying that “For years, our financial sector was governed by antiquated and poorly enforced rules that allowed some to game the system and take risks that endangered the entire economy.”<sup>1</sup>

All financial professionals—including insurance producers, investment advisors, broker-dealers and others—and not just the bad actors who motivated Congress to pass the Act, will be forced by the Act to change the way they do business. These changes almost invariably carry a steep learning curve and extract significant compliance costs for most professionals.

This Guide analyses the aspects of the Wall Street Reform Act that impact producers.

---

<sup>1</sup> National Underwriter Life and Health, *Obama Signs H.R. 4173 (7/21/2010)*, <http://www.lifeandhealthinsurancenews.com/News/2010/7/Pages/Obama-Signs-HR-4173.aspx?k=obama>.

## Authors



**Robert Bloink, Esq., LL.M.**

Robert Bloink worked to put in force in excess of \$2B of death benefit for the insurance industry's producers in the past five years. His insurance practice incorporates sophisticated wealth transfer techniques, as

well as counseling institutions in the context of their insurance portfolios and other mortality based exposures. Robert Bloink is a professor of tax for the Graduate Program of International Tax and Financial Services, Thomas Jefferson School of Law.

Previously, Robert Bloink served as Senior Attorney in the IRS Office of Chief Counsel, Large and Mid-Sized Business Division, where he litigated many cases in the U.S. Tax Court, served as Liaison Counsel for the Offshore Compliance Technical Assistance Program, coordinated examination programs audit teams on the development of issues for large corporate taxpayers, and taught continuing education seminars to Senior Revenue Agents involved in Large Case Exams. In his governmental capacity, Mr. Bloink became recognized as an expert in the taxation of financial structured products and was responsible for the IRS' first FSA addressing variable forward contracts. Mr. Bloink's core competencies led to his involvement in prosecuting some of the biggest corporate tax shelters in the history of our country.

Email: [rbloink@advisorfx.com](mailto:rbloink@advisorfx.com)



**Prof. William H. Byrnes, Esq., LL.M., CWM, Fellow**

William Byrnes is the leader of Summit Business Media's Financial Advisory Publications, having been appointed July 1, 2010. He has been an author and editor of 10 books and

treatises and 17 chapters for Lexis-Nexis, Wolters Kluwer, Thomson-Reuters, Oxford University Press, Edward Elgar, and Wilmington, as well as numerous commissioned, peer-reviewed, and law review articles. He was a Senior Manager, then Associate Director of international tax for Coopers and Lybrand, which subsequently amalgamated into PricewaterhouseCoopers, practicing in Africa, Europe, Asia, and the Caribbean.

He has been commissioned and consulted by a number of governments on their tax and fiscal policy from policy formation to regime impact. He has served as an operational board member for companies in several industries including fashion, durable medical equipment, office furniture, and technology. Since 1994, he has been a professional trainer for professional association conferences, government workshops, and financial service institutions in-house meetings.

Before Associate Dean Byrnes joined the administration of Thomas Jefferson School of Law, he was a tenured law faculty member at St. Thomas School of Law. He serves on the Academic Committee of the American Academy of Financial Management. He created the first online graduate program offered to wealth managers and life insurance producers without any legal background—see <http://llmprogram.tjsl.edu> (Graduate Program of International Tax and Financial Services, Thomas Jefferson School of Law).

Email: [wbyrnes@advisorfx.com](mailto:wbyrnes@advisorfx.com)

## **Table of Contents**

[Introduction](#)

[Fiduciary Standard](#)

[Accredited Investor](#)

[Mandatory Arbitration](#)

[Assets Under Management Cap](#)

[Private Fund Registration](#)

[Disclosures](#)

[FDIC Guarantee](#)

[Financial Planners](#)

[Indexed Annuities](#)

[Federal Insurance Office](#)

[Surplus Lines Producers](#)

[Performance Based Fees](#)

## The Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Wall Street Reform Act), signed into law by President Obama on July 21, 2010, was developed as a comprehensive response to the financial crisis of 2007-2010. President Obama summarized its purpose shortly after signing, saying that “For years, our financial sector was governed by antiquated and poorly enforced rules that allowed some to game the system and take risks that endangered the entire economy.”<sup>2</sup>

All financial professionals—including insurance producers, investment advisors, broker-dealers and others—and not just the bad actors who motivated Congress to pass the Act, will be forced by the Act to change the way they do business. These changes almost invariably carry a steep learning curve and extract significant compliance costs for most professionals.

In addition to compliance headaches created for financial professionals, the Act also “create[s]... an avalanche of new work for the executive branch,” which will be required to issue “520 rules, conduct 81 studies and issue 93 reports.”<sup>3</sup> Administering the rules and publishing the reports mandated by the Act will be the job of both existing executive agencies and agency subdivisions created by the Act. Some of the Wall Street Reform Act created subdivisions include: the Federal Insurance Office, a subdivision of the Treasury Department; the Consumer Financial Protection Bureau (CFPB), created by the Board of Governors of the Federal Reserve; and the Office of Financial Protection for Older Americans and the Office of Financial Literacy, both of which will exist within the CFPB. The Act also creates a Financial Stability Oversight Counsel, which will monitor systemic risks to the economy.<sup>4</sup>

Because the Act requires federal agencies to draft rules, and generally requires agencies to consider public comment before rule-making, the Act has set off an “intense effort by interested parties to shape the regulations that will implement the bill to their liking.”<sup>5</sup>

The Wall Street Reform Act includes big changes for financial advisors, the biggest being its shift of regulatory authority over many advisors from the Securities and Exchange Commission to the state governments. Also important to advisors will be the Act’s modification of the “accredited investor” standard, mandatory securities arbitration clauses, and performance-based fees. The Act will also bring most hedge fund (and other private fund) advisors under the SEC’s jurisdiction. A prominent issue raised by the Act for broker-dealers and their registered representatives will be the Act’s grant of authority to the SEC to apply a fiduciary standard to broker-dealers.

Although the Wall Street Reform Act focuses on financial institutions, it does not ignore the insurance industry or the perceived role of some large insurers in the meltdown. National Underwriter reports that, “For insurers, the bill generally retains state regulation of insurance while giving federal financial regulators authority to prevent future market meltdowns by forcing prompt correction action and, in a pinch, take over institutions, including insurers, that they deem constitute a potential systemic risk.”<sup>6</sup>

The Act also includes provisions that will streamline surplus lines insurance and reinsurance business. Of major importance for annuities issuers and producers is the Act’s conclusive definition of fixed indexed annuities as insurance products rather than securities.

---

<sup>2</sup> National Underwriter Life and Health, *Obama Signs H.R. 4173 (7/21/2010)*, <http://www.lifeandhealthinsurancenews.com/News/2010/7/Pages/Obama-Signs-HR-4173.aspx?k=obama>.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.*

<sup>5</sup> National Underwriter Property and Casualty, *President Signs Fin. Svcs. Reform; Insurers Turn Focus To Regs (7/21/10)*, <http://www.property-casualty.com/News/2010/7/Pages/President-Signs-Fin-Svcs-Reform-Insurers-Turn-Focus-To-Regs.aspx?k=dodd-frank>.

<sup>6</sup> *Id.*

What follows is a summary of provisions of the Wall Street Reform Act that are particularly important to insurance producers, investment advisors, and other financial professionals. More thorough treatment of these topics is given in the following pages.

## **Overview of the Wall Street Reform Act**

### *1. Ethical standards for investment advice given by broker-dealers*

The Act grants the SEC the power to impose a fiduciary standard on broker-dealers and their authorized representatives. While broker-dealers and their authorized representatives have previously escaped application of the heightened standard imposed on investment advisors, the Act homogenizes the standard used to evaluate advice given by all investment service providers—broker-dealers and advisors alike. Under the fiduciary standard, broker-dealers would be required to put their client's interests ahead of their own interests, meaning that they would be required to act in their clients' best interests and disclose any conflicts of interest.

### *2. "Accredited investor" standard for private placements*

The Wall Street Reform Act requires the SEC to evaluate the definition of "accredited investor," as it applies to individuals, and modify it as necessary "for the protection of investors, in the public interest, and in light of the economy." The SEC is given great latitude to define the term, except that the Act includes a specific provision requiring the SEC to revise the minimum net worth standard. This will reduce the number of investors who qualify as accredited investors.

### *3. Mandatory securities agreement arbitration*

The Act permits the SEC to prohibit or restrict mandatory securities arbitration agreements. At present, contracts between brokers, dealers, and investment advisors and their clients often include arbitration clauses. These arbitration clauses are typically upheld when challenged in the courts. Pushing disputes out of arbitration and into the courts will drastically increase expenses for both sides of these disagreements.

### *4. Jurisdiction over investment advisors*

States, and not the SEC, are given jurisdiction over investment advisors who manage between \$25 million & \$100 million in assets. But investment advisors who are registered in 15 or more states are subject to SEC regulation regardless of the amount of their assets under management. Prior to the Act, advisors with \$25 million or more in assets under management were subject to SEC regulation.

### *5. Regulation of hedge funds and private equity funds*

The Act requires hedge funds and private equity firms with more than \$150 million in assets under management to register as investment advisors with the SEC. These private funds were essentially unregulated before the Act based on the "private advisor exemption." Although the Act eliminates the private advisor exemption, it includes a number of exceptions from the registration requirement.

Private funds advisors that are exempted from registration by the SEC because they have less than \$150 million in assets under management will still be subject to enhanced recordkeeping requirements. These records must be kept open to inspection by the SEC. In addition to the recordkeeping requirement, the Act gives the SEC the power to impose examination and registration requirements on these otherwise exempted advisors.

#### 6. *Advisor disclosures*

The SEC is required by the Act to study investor access to information about advisors' professional backgrounds, including "disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information." The SEC is required to implement its recommendations within 18 months of completing the study.

#### 7. *Deposit insurance*

The Act permanently extends the FDIC's \$250,000 guarantee for deposits at banks, thrifts, and credit unions. The FDIC guarantee was previously \$100,000 per institution, but the guarantee was temporarily raised to \$250,000 during the financial crisis.

#### 8. *Study of state and federal regulation of financial planners*

The Government Accountability Office is required by the Act to study the adequacy of state and federal regulations designed to protect investors from persons who hold themselves out as financial planners "through the use of misleading titles, designations, or marketing materials." The study will also examine current State and Federal regulation of financial planners, and gaps in the regulation of financial planners and others who provide financial planning services.

#### 9. *Indexed annuities*

The Act conclusively settles the question of whether indexed annuities are securities subject to the SEC's jurisdiction by excluding indexed annuities from the definition of "security."

#### 10. *Creation of the Federal Insurance Office*

Insurance regulation has generally been left to the states; however, the Wall Street Reform Act may foreshadow future Federal oversight of the industry. The Act creates the Federal Insurance Office within the Treasury. The Office will monitor all components of the insurance industry-excluding the health, crop, and long-term care sectors. The Federal Insurance Office is mandated to conduct a study and provide recommendations to Congress on how to modernize insurance regulation in the United States. Among other considerations, the study will weigh the costs, benefits, and feasibility of Federal regulation of the insurance industry. The Office is also given authority to consult with the states and may even preempt state regulation in some specific areas.

#### 11. *Surplus lines dealers*

The Act streamlines the regulation of surplus lines insurance by making the insured's home state the sole regulator and tax collector in surplus lines transactions.

#### 12. *Performance-Based Fees*

The Act reduces the pool of clients who can be charged performance-based fees. Currently, "qualified clients" can be charged performance fees if they have at least \$750,000 in funds under management, or a net worth of over \$1,500,000. The Reform Act requires that the SEC adjust these funds under management and net worth threshold amounts to account for inflation starting on July 21, 2011, and then index them for inflation every five years thereafter.

## What You Don't Know Yet Might Hurt You: A Broker's Duties Under the Financial Reform Act

The Wall Street Reform Act<sup>7</sup>—signed into law by President Obama on July 21, 2010—significantly alters the relationship between broker-dealers and their retail customers, potentially increasing broker-dealers' exposure to lawsuits, decreasing their revenue, and constraining the range of products they are permitted to offer to their clients.

The Act grants the SEC the power to impose a fiduciary duty on broker-dealers and their authorized representatives. While broker-dealers have previously escaped application of the heightened standard imposed on investment advisors, the Act could homogenize the standard used to evaluate advice given by all investment service providers—broker-dealers and financial advisors alike.

The SEC has received hundreds of letters opposing a switch to a fiduciary standard for broker-dealers and their registered representatives. In addition to resistance from broker-dealers, some in the insurance industry are opposed to the change as well. *National Underwriter Life and Health* is reporting that, "insurance agents who sell only a limited number of financial products are sending in hundreds of letters to the Securities and Exchange Commission asking them not to hold them to a fiduciary standard when selling investment products."<sup>8</sup>

Although the Act has the potential to alter the professional landscape for brokers, the changes are neither immediate nor certain. Before imposing the fiduciary standard on broker-dealers, the Act mandates that the SEC conduct, and publish, a six month study comparing enforcement of the present suitability standard and the new, heightened fiduciary standard.<sup>9</sup>

The study period will provide time for business practices to be adjusted to comply with the new rules and also offers affected brokers and their authorized representatives an opportunity to shape the final product of the legislation, since the Act requires the SEC to seek and consider public comment during the study and prior to any rulemaking.<sup>10</sup>

National Underwriter reports that, so far, the "SEC analysis of comment letters by type indicates that 235 letters oppose a universal fiduciary standard, while 155 commentators support it." Other figures reported by NU show that many financial professionals are concerned: "1,641 persons or entities, mostly investment advisors and members of the National Association of Insurance and Financial Advisers, Falls Church, Va., have said the agency should maintain the current suitability standard for broker-dealers."<sup>11</sup>

The change to a fiduciary standard for broker-dealers also concerns insurers, who worry that the change will come to envelop their products and producers. The Senior Market Advisor, also an SB Media Company, reported that "The American Council of Life Insurers will be working to make sure regulators and others understand that the life insurance industry 'differs markedly from banking and securities'."<sup>12</sup>

---

<sup>7</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Wall Street Reform Act"), H.R. 4173.

<sup>8</sup> National Underwriter Life and Health, [SEC Comment Letters Show Most Agents Oppose Fiduciary Standard](http://www.lifeandhealthinsurancenews.com/News/2010/8/Pages/SEC-Comment-Letters-Show-Most-Agents-Oppose-Fiduciary-Standard.aspx) (8/27/2010), <http://www.lifeandhealthinsurancenews.com/News/2010/8/Pages/SEC-Comment-Letters-Show-Most-Agents-Oppose-Fiduciary-Standard.aspx>.

<sup>9</sup> Wall Street Reform Act § 913(b), (c).

<sup>10</sup> Wall Street Reform Act § 913(e).

<sup>11</sup> National Underwriter Life and Health, [SEC Comment Letters Show Most Agents Oppose Fiduciary Standard](http://www.lifeandhealthinsurancenews.com/News/2010/8/Pages/SEC-Comment-Letters-Show-Most-Agents-Oppose-Fiduciary-Standard.aspx) (8/27/2010), <http://www.lifeandhealthinsurancenews.com/News/2010/8/Pages/SEC-Comment-Letters-Show-Most-Agents-Oppose-Fiduciary-Standard.aspx>.

<sup>12</sup> Senior Market Advisor, *Wall Street Reform Act Begins a New Regulatory Era for Industry* (7/29/2010), <http://www.seniormarketadvisor.com/News/2010/7/Pages/Wall-Street-Reform-act-begins-a-new-regulatory-era-for-industry.aspx?k=dodd+frank+wall+street>.

## Changing Standards

Broker-dealers are presently subject to a *suitability standard* under which a broker-dealer must reasonably believe that his or her advice is suitable to the client's financial situation. In determining whether advice is suitable to the client, the broker-dealer is required to have "an adequate and reasonable basis" for his or her recommendations, meaning that he or she must make reasonable efforts to obtain information about the customer's financial status. For the most part, brokers are not currently required to disclose potential conflicts-of-interest to their clients.

The Wall Street Reform Act permits the SEC to step-up broker-dealers' duties to their clients to a *fiduciary standard* on par with the standard applied to financial advisors. Under the fiduciary standard, broker-dealers would be required to put their client's interests ahead of their own interests. This means that they would be required to act in their clients' best interests and disclose any conflicts of interest. So, for example, under the fiduciary standard, a broker would not be permitted to factor the size of his commissions into the development of his advice. The Act also permits the SEC to require brokers who exclusively sell a limited range of financial products to disclose that fact to their clients.<sup>13</sup>

While passage of the Wall Street Reform Act will likely result in a ratcheting-up of the standard applied to evaluate brokers' advice to their clients—requiring full-disclosure of the broker's interests in a transaction—the Act specifically states that a commission-based fee structures does not, in and of itself violate the fiduciary standard.<sup>14</sup>

## Conclusion

Opposition to the shift to a fiduciary standard is summarized well by a financial professional quoted in a recent NU article: "[I]mposing legal fiduciary liabilities to an already heavily regulated industry in which registered representatives must already undergo rigorous compliance will only hurt our clients by adding another layer of regulation and more costs."<sup>15</sup>

Although resistance to the change is strong, we are likely to find the broker/client relationship significantly altered when the dust dislodged by the Wall Street Reform Act clears. But the final shape of these changes is still unsettled. The next six months hold a high degree of uncertainty for broker-dealers and their registered representatives as the SEC conducts its six-month study of the proposed changes.

---

<sup>13</sup> Wall Street Reform Act § 913(g).

<sup>14</sup> Wall Street Reform Act § 913(g).

<sup>15</sup> National Underwriter Life and Health, *SEC Comment Letters Show Most Agents Oppose Fiduciary Standard* (8/27/2010), <http://www.lifeandhealthinsurancenews.com/News/2010/8/Pages/SEC-Comment-Letters-Show-Most-Agents-Oppose-Fiduciary-Standard.aspx>.

## **Wall Street Reform Act Re-Defines “Accredited Investor”**

The definition of “accredited investor” will narrow over the next few years, although its final form will not be fixed immediately. The Wall Street Reform Act takes two steps that will change the definition of “accredited investor.” First, the Act includes an amendment to the rule that takes effect immediately, changing the calculation of an investor’s net worth for purposes of the rule. Second, the Act also gives the SEC broad powers to further modify the rule. Depending on how the SEC decides to change the rule, the second change will change the investing landscape for a large number of investors. Narrowing the definition of “accredited investor” will significantly reduce the number of investors who qualify under securities laws to enter into higher risk investments.

### ***Amendments to the Accredited Investor Standard***

Accredited investors are permitted by the SEC to put their money into higher risk investments that are off-limits to the average-Joe investor. The definition of “accredited investor” includes both high-net-worth individuals and institutional investors. Individuals are qualified as accredited investors if they satisfied either a yearly income standard or a net-worth standard. The Wall Street Reform Act amends the net-worth standard, although it leaves the income standard alone. Under the income standard an individual with an annual income of \$200,000 in each of the two most recent years, or a married couple with an annual income of \$300,000 in each of the two most recent years, is an accredited investor. Prior to passage of the Wall Street Reform Act, individual investors could also be qualified as accredited investors if they had a net worth, or joint net worth with their spouse, of more than \$1 million, including the value of the investor’s principal home.

The Wall Street Reform Act changes the net worth rule to exclude an investor’s principal residence from the net worth calculation. Under the new rule, effective immediately, individuals (or married couples) are qualified as accredited investors if they have a net worth of at least \$1 million, excluding the value of the investors’ principal residence. Although this change will exclude some investors from classification as accredited investors, the Act prohibits the SEC from raising the net worth requirement further, fixing the net worth standard at \$1 million for another four years. However, at the close of that four-year period, the SEC is required to evaluate the requirement and increase the amount. The SEC is not just permitted, but is mandated, to raise the net worth requirement, so change is absolutely certain in four years.

In addition to the immediate change to the net-worth calculation, the Wall Street Reform Act also requires the SEC to evaluate the definition of “accredited investor,” as it applies to individuals, and modify it as necessary “for the protection of investors, in the public interest, and in light of the economy.” The SEC is given great latitude to define the term. While the final result of the SEC’s study and rulemaking are uncertain, the changes will be considerable.

### ***Results of the Rule Change***

Narrowing the definition of “accredited investor” will shrink the pool of investors who qualify to enter into higher risk investments like private placements and hedge funds. And because a business is an accredited investor if all its equity members are accredited investors, changes in the definition of individual accredited investor will also reduce the pool of corporations and other businesses that are permitted to invest in higher-risk investments. Businesses with more than \$5 million in assets will not be affected by the mandatory rule change, although the SEC has latitude to change that rule as well.

Although the results of the SEC study of the accredited investor standard and any attendant rule change are years off, hints about the SEC’s intent are available since the SEC has previously proposed changes to the definition of accredited investor. The SEC amended definition of “accredited investor” may end up being more than simply an inflation adjustment to the requirement. In 2006, the SEC proposed a rule change that would have imposed a net-investments test on investors in hedge funds and other private investment pools like private equity firms. The proposed rule would require that investors in private funds to have net investments of at least \$2.5 million before being allowed to invest in private funds. The

net investments standard would be applied in addition to the existing accredited investor standard and would be adjusted periodically for inflation. Because only investments would be considered in the calculation, a person's principle home and primary business real estate would not be aggregated into the total.

An SEC rule change like the \$2.5 million net investment requirement would reduce the pool of accredited investors by 88% or more according to the SEC's estimate. Much of this change will relate to the inflation adjustment since the \$1 million floor has not been adjusted for inflation since its inception. The \$1 million net-worth requirement was created in 1982, a time when only about 1.87% of U.S. households qualified under the net worth standard. As of 2006, that number had risen to 8.5% of U.S. households. The SEC's proposed rule change would reduce the number of U.S. households satisfying the accredited investor standard to about 1.29% of U.S. households. Much of this change is essentially an inflation adjustment reducing the pool of accredited investors back to 1982 levels, although some of the reduction goes beyond pure inflation adjustment.

Regardless of whether the SEC decides to apply its previously announced investment requirement or makes other amendments to the accredited investor standard, some investors will suddenly find themselves unable to make investments in private funds and private placements. Although many individuals who will no longer qualify as accredited investors do not participate in restricted investments, rule changes will likely shift some capital from riskier investments like hedge funds to stocks, bonds, mutual funds and insurance and annuity products.

## **Mandatory Securities Arbitration Clauses on the Chopping Block**

The Wall Street Reform Act expressly gives the SEC the power to prohibit or restrict mandatory securities arbitration agreements. Although securities arbitration would still be permitted if the SEC decides to act, arbitration would likely be used only at the client's option, effectively shifting the choice of whether to arbitrate from financial professionals to their clients.

Currently, most contracts between financial services firms and their clients include mandatory arbitration clauses. Arbitration has been favored by the courts, with mandatory arbitration clauses typically being upheld on challenge. This preference for arbitration over litigation has resulted in nearly 100% of advisor-client disagreements being settled through arbitration.

Opponents of mandatory arbitration clauses believe that the agreements are unfair to consumers, allowing financial professionals and their attorneys to game the system to the detriment of consumers. But pushing disputes out of arbitration and into the courts will drastically increase dispute expenses for both clients and their advisors while increasing uncertainty in disputes.

### ***Mandatory Securities Arbitration Agreements***

The Wall Street Reform Act gives the SEC the power to restrict or prohibit enforcement of mandatory arbitration clauses relating to disputes "arising under the Federal securities laws, the rules and regulations thereunder, or the rules of a self-regulatory organization." Note that the Act does not give the SEC the power to prohibit all mandatory arbitration clauses; disagreements arising under state securities laws are not included in the grant of authority.

Brokerdealers' agreements typically mandate FINRA arbitration of broker-client disputes, while investment advisors' agreements mandate arbitration with a commercial arbitration provider. With near universal reliance on arbitration for settling securities disputes, imposition of any restriction on mandatory arbitration will have a dramatic effect on advisors and broker-dealers handling of disputes.

### ***Mandatory Securities Arbitration Prior to the Wall Street Reform Act***

Institution of a ban on mandatory securities arbitration clauses would likely introduce confusion into the dispute process for both advisors/brokers and their clients. Prior to the 1986 Supreme Court decision in *Shearson/American Express v. McMahon (McMahon)*, mandatory securities arbitration clauses were enforceable only regarding state law claims. Arbitration for Federal claims was available, but clients were given the choice of forum for disputes.

But because most securities claims touch on both state and federal securities laws, prior to *McMahon* there was significant confusion about splitting of state and federal securities claims so that state claims could be arbitrated while federal claims went before a federal court.

If the SEC exercises the power to prohibit mandatory securities arbitration, this confusion will be reintroduced into the advisor-client relationship and will introduce further uncertainties and costs for financial professionals and their clients.

### ***Is Arbitration Fair?***

Most arguments for the elimination of mandatory arbitration agreements center on the perceived unfairness of the process for financial professionals' clients. Some commentators argue that arbitration and other forms of private dispute resolution are not fair and efficient because private individuals fill arbitration panels instead of professional jurists. Arbitrators are generally not bound to apply existing law when rendering their decisions and often do not publish their reasoning when rendering a decision. Because an arbitrator's decision-making is conducted in the dark, disputants can never be certain whether justice was done in resolving a dispute.

Due in part to the un-published nature of arbitration, many investors tend to have negative opinions about arbitration, believing that arbitrators are biased. Also, some of arbitration's critics and participants believe that arbitrators are beholden to financial institutions. Critics suggest arbitrators may be biased in favor of the institutions that make the choice of arbitrator more frequently than any one client. Thus, even if arbitration is largely a fair process producing fair results for both sides of a dispute, the process can be tainted by public perceptions of unfairness.

Private dispute resolution like arbitration is often hailed for putting the resolution of disagreements in the hands of the parties instead of a judge. Parties can choose to arbitrate a claim and even choose the arbitrators assigned to decide the case. But because most advisors and broker-dealers' client contracts include a mandatory arbitration clause, clients have little choice in the matter. They can either place their money with an advisor or not, but for the most part, they cannot avoid arbitration if a dispute with an advisor or broker escalates to require third party intervention.

Arbitration was trumpeted as a cheaper alternative to litigation, but that assertion has never been proven definitively. Because arbitration awards are often confidential, and arbitrators generally do not give reasons for their decisions, the question of whether arbitration is generally fair cannot be answered conclusively. Although arbitration is generally viewed as a fair alternative to litigation, some empirical studies disagree, with one finding that claimants fared increasingly poorly in arbitration between 1995 and 2004, especially in disagreements with larger firms and repeat players and where the claim was large. In fact, the average recovery in the arbitrated claims considered by that study was only 12% of the claim after attorney's fees and expenses. Other empirical studies have reached the opposite conclusion, finding that outcomes in arbitration are generally fair to both consumers and professionals. These ambiguities should give the SEC pause when considering whether to institute a total ban on mandatory arbitration clauses.

A rule instituting voluntary securities arbitration could also harm some clients by allowing investment professionals to force litigation for small claims that do not warrant the client's expense of going to trial. Depending on the final form of SEC mandatory arbitration rules, clients who prefer arbitration may be forced into litigation if the financial professional on the other side of the dispute prefers litigation and refuses to arbitrate a claim. Arbitration that is voluntary for both parties to a dispute could thus harm clients who cannot afford litigation or whose portfolios are too small to warrant the expense.

## ***Conclusion***

The SEC may recognize the substantial costs that a ban on mandatory arbitration clauses will have on both clients and financial professionals and craft a rule that restricts, rather than prohibits, mandatory arbitration clauses. Although a flat-out ban on mandatory arbitration clauses would create inefficiencies for both clients and their advisors, a well-crafted rule could introduce client choice into the equation while simultaneously protecting the interests of advisors and broker-dealers. What is certain is that, unless the SEC decides to maintain the status quo—continuing to permit mandatory arbitration agreements—SEC action will cost everyone, including both financial professionals and their clients.

## The Wall Street Reform Act Shifts Advisors from SEC to State Regulation

The Wall Street Reform Act made sweeping changes to the regulatory map for investment advisors, shifting a significant number of advisors away from SEC regulation into the fold of state regulators. These changes will take place on July 21, 2011, the one-year anniversary of the bill's signing. The shift away from federal regulation for smaller advisors will enhance the SEC's ability to police larger institutions, like those implicated in the financial crisis. Although some advisors may benefit from the change, the Act will cost smaller advisors big, requiring them register in numerous states instead of with the centralized SEC. These compliance costs will favor federally regulated firms, pushing smaller firms to grow themselves to meet the threshold for federal regulation.

Prior to the Act, advisors with less than \$25 million in assets under management were required to register with a state regulator. Advisors with \$25 million or more in assets under management were permitted, and those with over \$30 million in assets under management and more than 14 clients were required, to register with the SEC.

The Wall Street Reform Act changes the dividing line between state and federal regulation. Under the Act, an advisor is not permitted to register with the SEC if:

- (1) it is required to register as an investment advisor in the state in which it has its principal office and place of business *and*
- (2) it has between \$25 million and \$100 million in assets under management.

In other words, most advisors managing between \$25 million and \$100 million will be forced to register at the state level. Those who are presently registered with the SEC but no longer qualify for SEC registration will be required to deregister with the SEC. Note that these registration prohibitions do not apply to registered investment companies or registered business development companies.

Some investment advisors will be permitted to register with the SEC even if they do not have more than \$100 million in assets under management. Advisors who are registered in 15 or more states are permitted to register with the SEC if they have between \$25 million and \$100 million in assets under management.

The North American Securities Administrators Association (NASAA) has estimated that the Reform Act will shift regulation of about 4,000 of 11,500 SEC registered advisors from the SEC to the states. Some states have moved ahead with transition plans for incoming advisors, and the SEC has promised guidance on the process. The process of shifting from federal regulation to state regulation will be daunting for some advisors, especially those who will now be required to register in more than a dozen states. Each state will impose different regulatory and filing requirements on advisors, levying a heavy cost for initial compliance and exponentially increasing annual compliance costs as well. Because larger, federally regulated firms will benefit from centralized registration, smaller firms will either grow to meet SEC registration thresholds or face significantly decreased revenue.

## **Hedge Fund Must Now Register with the SEC Under the New Wall Street Reform Act**

The Dodd-Frank Wall Street Reform and Consumer Protection Act—signed into law by President Obama on July 21, 2010—will shine a regulatory light into a few of Wall Street's darkest corners. Motivated by the perceived role of exotic financial instruments and unregulated market players in the recent financial crises, Congress used the Act to expand the Securities and Exchange Commission's (SEC) reach. Credit default swaps and private funds like hedge funds, which until now have lived on the fringe of the regulated markets, will be subject to SEC regulation for the first time. While providing only a window into the inner workings of such hedge funds, this could be a significant step toward a wider imposition of regulation on the financial services business by the federal government.

The Private Fund Investment Advisers Registration Act of 2010, part of the Wall Street Reform Act, will require registration of many hedge fund managers who previously escaped registration with the SEC. Hedge fund, and other private fund, managers who do not fit into one of the Act's exemptions will be required to register with either the SEC or a state regulatory agency. Advisors to larger funds will be required to register with the Securities and Exchange Commission (SEC), while advisors to smaller funds will be required by the Act to register at the state level. The private fund registration requirements of the Act will start on July 21, 2011.

### **Who Must Register?**

The Act requires advisors to hedge funds and private equity funds with more than \$150 million in assets under management to register as investment advisors with the SEC. Managers with assets under management of between \$25 million and \$150 million will be required to register with state regulators. Those with less than \$25 million in assets under management are exempt from the federal registration requirement, but may be subject to registration requirements under state law.

*Investment Advisor*, a publication of SB Media, reported after the bill was signed that “not only will most investment advisors now be required to register, they will also be faced with more onerous reporting obligations”. “Therefore, advisors need to consider how they will respond to the heightened scrutiny and the SEC's new demands.”<sup>16</sup>

This is not the first time hedge funds have faced a registration requirement, although this is the first broad-based registration requirement promulgated by Congress. In 2004 the SEC expanded the registration requirement for private funds, bringing many previously unregistered funds under its jurisdiction. That registration requirement was struck down by the Court of Appeals in 2006. This time, however, there is unlikely to be any such reprieve from the Act's registration requirement. Instead, some private funds will be forced to find ways around the requirement by structuring themselves and their transactions to satisfy one of the Acts many registration exemptions.

### **Private Advisor Exemption Under the Advisors Act**

Prior to passage of the Wall Street Reform Act, many private funds were essentially unregulated based on the “private advisor exemption” to the registration requirement. The Act brings private funds under the SEC's regulatory bailiwick by eliminating the private advisor exemption.

In general, investment advisors must register with the SEC unless they satisfy a registration exception. Prior to the Wall Street Reform Act, many venture capital, private equity and hedge fund advisors used the “private advisor exemption”—granted by the Investment Advisors Act of 1940—to avoid

---

<sup>16</sup> Investment Advisor, *SEC's New Powers Affect Hedge Fund and Private Equity Advisors* (7/29/2010), <http://www.investmentadvisor.com/News/2010/7/Pages/SECs-New-Powers-Affect-Hedge-Fund-and-Private-Equity-Advisors.aspx>.

registration. In general, an advisor is a “private advisor” if it has no more than 14 clients in any calendar year and does not hold itself out to the public as an investment advisor.

Many funds satisfied the private advisor exemption because their clients were not individuals, but organizations. A fund with 14 entities as clients would satisfy the private advisor exemption even if its clients themselves had significant membership. In that way, a hedge fund’s actions could affect a large pool of individuals without being subject to the registration requirement. The SEC attempted to significantly narrow the private advisor exemption in 2004 by closing this perceived loophole. Registration rules were revised to require every fund manager to aggregate the clients of each of a fund’s investors for the purposes of determining whether the 14 client limit had been reached. Many funds complied with the newly strengthened registration requirement, but in 2006, the D.C. Court of Appeals overturned the rules. Although it took another four years, Congress stepped in, permanently changing the regulatory environment for hedge funds.

### **Registration Exemptions Under the Wall Street Reform Act**

Although the Act eliminates the private advisor exemption and will increase the SEC’s stable of registered private funds, the Act does include a number of exceptions that some funds will rush to satisfy. The following types of advisors will be exempt from the Act’s registration requirement:

- (a) **Mid-Sized Private Fund Advisors**—An advisor who acts solely as advisor to private funds and who has less than \$150 million in assets under management
- (b) **Venture Capital Fund Advisors**—Advisors who act as advisors only for venture capital funds
- (c) **Foreign Private Advisors**—Foreign private advisors, if they (1) do not have a place of business in the U.S., (2) have fewer than 15 U.S. clients and investors in private funds advised by the advisor, (3) have assets under management of less than \$25 million (4) do not hold themselves out as an investment advisor in the U.S., and (5) do not act as advisors to any registered investment companies or business development companies
- (d) **Family Offices**—Advisors to family offices, although the term “family office” is left undefined by the Act
- (e) **Commodity Trading Advisors**—Advisors registered with the Commodity Futures Trading Commission, if they do not give advice about securities, and
- (f) **Small Business Investment Company Advisors**—Advisors who exclusively advise small business investment companies.

The Act also narrows the registration exemption for intrastate advisors. The intrastate exception exempts from registration some advisors whose clients are all residents of the same state. The Wall Street Reform Act eliminates the intrastate exemption for advisors to private funds, although the exemption will still be available for other advisors.

### **Recordkeeping and Reporting Requirements for All Advisors to Private Funds**

Although some private fund advisors will be exempted from registration, the Act gives the SEC the power to subject unregistered firms to enhanced recordkeeping requirements. These records must be kept open to inspection by the SEC.

Information required to be kept by private advisors includes:

- (a) The amount of assets under management and use of leverage, including off-balance-sheet leverage
- (b) Counterparty credit risk exposure
- (c) Trading and investment positions
- (d) Valuation policies and practices of the fund

- (e) Types of assets held
- (f) Side arrangements or side letters, whereby certain investors in a fund obtain more favorable rights or entitlements than other investors
- (g) Trading practices, and
- (h) Other information that is appropriate in the public interest and for the protection of investors and for the assessment of systemic risk.

In addition to the recordkeeping requirement, the Act gives the SEC the power to impose examination and registration requirements on these otherwise exempted advisors.

### ***Confidentiality Protections***

The Act's recordkeeping requirements include confidentiality protections for some fund and client data. Proprietary information provided by funds to the SEC under the Act is not subject to Freedom of Information Act requests. Proprietary information includes non-public information about: (1) investment and trading strategies; (2) analytical and research methodologies; (3) computer hardware and software that hold intellectual property; (4) other information deemed proprietary by the SEC.

In addition to other exceptions, the Act allows the SEC to request confidential client information from a private fund in connection with enforcement investigations and proceedings and also "for purposes of assessment of potential systemic risk."

### **The Changing Environment for Hedge Funds**

The Wall Street Reform Act drastically changes the environment for hedge funds and other private funds. Although the Act's registration requirements will force registration of most funds, some funds may be enticed offshore by the compliance and other costs associated with the reform effort.

The Wall Street Reform Act is a first step toward comprehensive regulation of the financial world that will likely be followed by many, probably smaller, steps. The success of the Act over the next couple of years and the outcome of the next two election cycles will determine Congress's regulatory posture. If the Act is a perceived success, Congress will be emboldened to expand the federal government's reach even further into financial matters. The next logical step for Congress—and one that is being considered now—is federal regulation of insurance. Stay tuned. The next few years will be interesting.

## Enhanced Disclosures Under the Wall Street Reform Act

The Wall Street Reform Act lays the groundwork for increased advisor and broker-dealer disclosure requirements. First, the Act requires the SEC to conduct a study looking for ways to improve investor access to information about advisors' professional backgrounds. Second, the Act gives the SEC broad powers to institute disclosure requirements for broker-dealers. These forthcoming SEC disclosure rules may dramatically alter the nature of required client communications. If the newly imposed "Plain English" disclosure rules applicable to RIA's is any guide, these new broker-dealer disclosure rules may forever alter what registered representatives are required to share with their clients.

Advisor information considered in the SEC study will include "disciplinary actions, regulatory, judicial, and arbitration proceedings, and other information." While much of this information is already available on FINRA's Central Registration Depository and the Investment Advisor Registration Depository, the question will be how much of this information broker-dealers and their representatives will affirmatively be required to bring to a new client's attention. The degree and character of this enhanced disclosure will be made clear at the close of the SEC study, when the SEC is required to make recommendations in light of its findings and implement those recommendations within 18 months.

The Wall Street Reform Act also gives the SEC broad powers to create rules designating documents or information that broker-dealers must provide to retail investors prior to purchase of investment products or services. The Act does not specify what type of information must be provided giving the SEC near absolute discretion to craft the requirements. But the Act does require that any documents or information mandated by SEC rules issued under this authority must be in summary form and include "clear and concise information about... investment objectives, strategies, costs, and risks." The SEC required information must also include information about a broker-dealer's compensation and other incentives in connection with the investment product.

The study of client access to advisor information and the SEC's recently announced plain English requirement for client disclosures signal a renewed Federal interest in disclosures about advisors' backgrounds. The Wall Street Reform Act's disclosure provisions will activate about the same time as the SEC's plain English disclosure requirement. As of January 1, 2011, the Securities and Exchange Commission will require advisors to make plain-English disclosures to their clients, laying out the advisor's business practices, conflicts of interest, and the background of the firm and its personnel. As discussed in Professors Byrnes and Bloink's August 25, 2010 AdvisorFX Advisor's Journal, the [Plain English requirement](#) will cost advisors both time and money.

While enhanced disclosure requirements may contribute to client confidence in their financial professionals, a complex web of disclosures may also scare advisors and their firms into producing voluminous disclosures in an overzealous attempt to avoid liability by covering every possible contingency. Clients will never read a phonebook-sized disclosure document, even if every sentence is packed with information vital to their financial interests. That's the irony of disclosure: the more thorough the disclosure, the less likely the disclosure will ever be read by the people who would benefit the most from the information.

Even if broad disclosure requirements allow investors to avoid the few bad apples, they also may hurt honest advisors by costing them time and money. Undoubtedly, the coming additional costs of compliance will be significant. We can only hope the added disclosure, on the whole, adds to the overall confidence of broker-dealers' clients.

## **FDIC Guarantee Increased to \$250,000**

The Wall Street Reform Act permanently extends the FDIC's \$250,000 guarantee for deposits at banks, thrifts, and credit unions. The FDIC guarantee was previously \$100,000 per institution per depositor, but the guarantee was temporarily raised to \$250,000 during the financial crisis. The permanent increase has incentivized some risk-averse, higher-income clients to permanently allocate a larger percentage of their funds with banks and other FDIC insured financial institutions. The increase comes at the cost of client allocations to more traditional investment products, insurance solutions, and annuities. Increasingly, we see clients opening accounts with other insured institutions to maximize the \$250,000 guarantee. What many highly risk-averse clients do not realize is that there are opportunities to multiply the \$250,000 guarantee many times over at a single institution, depending on how accounts are titled and who is named beneficiary of the account.

### ***Multiplying the \$250,000 Guarantee***

For investors interested in keeping their funds in near cash equivalents like CDs, the increased guarantee makes it more convenient to take that safe route. And there are opportunities to multiply the \$250,000 guarantee at a single institution. The type of accounts owned by an individual will determine whether the amounts held in those accounts will be added together when applying the guarantee.

All single accounts—those with one owner and no beneficiaries designated to receive the funds at the owner's death—with a particular institution are aggregated for purposes of the guarantee. Single accounts include checking, savings, CD and money market deposit accounts. So if a depositor has a \$100,000 savings account, a \$100,000 checking account, and a \$200,000 CD at a single covered institution, those accounts will be added together for purposes of figuring out how much of the depositor's funds are insured. In this example, all of the depositor's funds are added together, meaning that \$250,000 is covered while \$150,000 is left uncovered. Like single accounts, all joint accounts owned by a particular person at a single institution are aggregated for purposes of the guarantee.

Accounts with named beneficiaries are insured as revocable trust accounts. Trust accounts are the best way to multiply the guarantee since the owner of a qualifying revocable trust account is entitled to up to a \$250,000 guarantee for each beneficiary named on the account, depending on whether beneficiaries have an equal interest in the account. But care must be taken that the formal requirements for an FDIC insured revocable trust account are satisfied, because if the requirements for a trust account are not met, the account will be combined with the owner's other accounts for purposes of calculating the guarantee. In order for an account to be treated as a trust account, it has to satisfy the following requirements:

- (1) The account title must include a designator signifying it's held in a trust relationship. Payable on death (POD), in trust for (ITF), and as trustee for (ITF) satisfy this requirement.
- (2) Beneficiaries must be named in either deposit account records or identified in the trust document, if any.
- (3) To be eligible for the guarantee, a beneficiary must be either a living person or an IRS qualified charity or non-profit.

Determining FDIC coverage of an account with equal beneficiaries is relatively straightforward, but calculation of the guarantee when beneficiaries have an unequal interest in the trust can be more complicated.

Unlike the FDIC guarantee of a revocable trusts—where the account owner and not beneficiaries receive the benefit of the guarantee—beneficiaries of an irrevocable trust are each guaranteed up to \$250,000. But in order to qualify for the \$250,000 guarantee, a beneficiary's interest in the trust cannot be contingent. As a result, most irrevocable trust account will have the benefit of only a single \$250,000 guarantee.

In addition to accounts like checking, savings, and money market deposit accounts, some retirement accounts—like IRAs, Roth IRAs, and self-directed Keogh plans—held at covered institutions are also covered by the \$250,000 guarantee. The amounts of all of an individual's retirement accounts held at a single covered institution will be added together to calculate the guarantee. Retirement accounts are not added to an individual's other accounts when calculating the insured amount.

Also, a business's accounts are combined together and guaranteed up to \$250,000. But those accounts are not aggregated with the business owner's accounts, so business accounts offer another opportunity to multiply the FDIC guarantee.

### ***Conclusion***

Hopefully, the permanent \$250,000 guarantee increase doesn't decrease the attractiveness of uninsured investment accounts and insurance products for the long term. However, fear brought on by the 2007-2010 financial crisis is still keen, especially when suggestions of a W shaped recession continue. As financial firms and insurance company failures begin to fade from memory, clients will come back to investing and planning, but along the way they'll benefit from the expert assistance and assurances of their financial team before jumping back into the fray. In the meantime, information about how accounts are combined for purposes of the FDIC guarantee will be valuable for risk-averse clients.

## **Wall Street Reform Act Mandates Study of Financial Planning Industry**

The federal government is taking the first steps toward regulating financial planners. The Financial Planning Association and other industry groups are welcoming the prospect of federal oversight. The federal push toward regulation is motivated by a perceived widespread misuse of “Financial Planner” and other similar designations.

The Wall Street Reform Act requires the Government Accountability Office to study state and federal regulation of persons who hold themselves out as financial planners. The study will consider whether there are regulatory gaps in federal and state law that permit unregistered financial planners and others who provide planning services to escape regulation. The use of “misleading titles, designations and marketing materials” by financial planners will also be scrutinized to determine whether current law adequately protects consumers.

Advisors who are also Certified Financial Planners may ultimately face a second layer of federal regulation. However, the effort may be a positive step toward eliminating some unethical players from the market. As the study results are reported back to Congress, they will likely hint at whether this initiative will lead to an added layer of compliance and federal oversight regulating the “Financial Planner” designation.

## Indexed Annuities: Still Insurance

After a series of contradictory indicators from the SEC and the courts, Congress finally settled the question of whether fixed indexed annuities (FIAs) are securities or insurance products. The Dodd-Frank Wall Street Reform and Consumer Protection Act—signed into law by President Obama on July 21, 2010—conclusively excludes FIAs from regulation as securities by the Securities and Exchange Commission (SEC).

The certainty offered by the Wall Street Reform Act is a relief for both annuity issuers and producers. *Life Insurance Selling*, a Summit Business Media publication, reported in August that “[t]he fixed indexed annuity community is understandably ecstatic at the regulatory developments that have occurred within the past month, particularly in light of how many sleepless nights that same community suffered since the SEC proposed its ill-fated Rule 151A back in the summer of 2008.”<sup>17</sup>

Nevertheless, annuities are still subject to pricing changes given the new regulation. National Underwriter reports that other provisions of the Act “could increase the cost of the derivatives that insurers use in annuity programs.”<sup>18</sup> The August NU article quoted the vice president of financial management for a major National Insurer, who stated that he “would anticipate that the providers of the long dated equity-linked derivatives that we use in our annuity business may be required to hold more capital.” Another insurance company quoted by NU “believes the new derivatives clearing, margin and capitalization rules will increase the cost of its hedging program.” And another company stated that “the new derivatives requirements could reduce its liquidity and increase the cost of the derivatives it uses to protect itself against the risk associated with annuity guarantees.”<sup>19</sup>

### Classification of Annuities

Annuity products fall on a spectrum. On one end are products that are clearly classified as insurance. On the other end are products that are clearly investment products. Products that shift investment risk to the insurance company are typically classified as “insurance,” and products that shift investment risk to the purchaser tend to be classified as “investments.” This classification is important because most investment products are regulated by the SEC, which imposes a host of compliance issues for dealers.

There are clear examples of annuity products that fall on each end of the spectrum. Variable annuities—which shift most or all of the investment risk to the purchaser and away from the insurance company—are the obvious case of a product that falls on the “investment” side of the spectrum. Fixed annuities—which guarantee the purchaser’s return, shifting almost all investment risk to the insurance company—are the clearest example of a product falling on the insurance side of the spectrum.

Although fixed and variable annuities are easily classified, many annuity products are not so easily placed. Indexed annuities are one of those ambiguous products that fit somewhere between an insurance product and an investment product. The minimum return on an indexed annuity is guaranteed, making the indexed annuity appear more like an insurance product. But the return on an indexed annuity may exceed that guaranteed return based on the performance of a securities index like the Dow Jones Industrial Average, making fixed indexed annuities appear more like securities.

### SEC Seizes Control of Indexed Annuities

Before the SEC stepped in and ruled that indexed annuities are, insurance producers sold indexed annuities under the assumption that these annuities were insurance contracts subject to state regulation.

---

<sup>17</sup> Life Insurance Selling, *What's Going On - 151A is Dead. Now What?* (8/3/2010), <http://www.lifeinsuranceselling.com/Issues/2010/August-2010/Pages/Whats-Going-On--151A-is-dead-Now-what.aspx>.

<sup>18</sup> National Underwriter Life and Health, *Annuity Issuers Eye Dodd-Frank Act* (8/5/2010), <http://www.lifeandhealthinsurancenews.com/News/2010/8/Pages/Annuity-Issuers-Eye-DoddFrank-Act.aspx>.

<sup>19</sup> *Id.*

But on January 8, 2009, the SEC issued Rule 151A, which would have classified indexed annuities as securities subject to the SEC's authority. If the rule had gone into effect only those licensed to sell securities would have been permitted to sell indexed annuities.

The rule was poised to take effect on Jan. 12, 2011, but in July 2009, insurers brought a lawsuit to stop SEC enforcement of the rule. The D.C. Circuit Court of Appeals sided with the insurers, ruling that the SEC had not adequately analyzed the economic effect of the rule before adopting it, as required by law. The ruling required the SEC to conduct a legally acceptable study before enforcing the rule. Because the SEC failed to conduct an adequate study, the Court vacated Rule 151A in July of 2010, requiring the SEC to go back to the drawing board and start the regulatory process over.

Congress stepped in before the SEC could reissue a rule on indexed annuities, inserting a provision into the Wall Street Reform Act that excludes indexed annuities from the definition of "security." Less than a month after the Court vacated Rule 151A, the Wall Street Reform Act was signed into law and indexed annuities are free and clear of SEC regulation. These successive acts by the judicial and then the legislative branches finally ended the uncertainty associated with indexed annuities, and "[t]he SEC's dreams of regulating FIAs as securities were dealt a double-fisted knockout."<sup>20</sup>

---

<sup>20</sup> Id.

## **The Federal Insurance Office**

Although regulation of insurance generally has been left to the states, the Wall Street Reform Act may foreshadow future federal oversight of the industry. The Act creates the Federal Insurance Office (FIO) within the Treasury, which will monitor all components of the insurance industry—excluding the health, crop, and long-term care sectors. The FIO is not a regulatory or supervisory body, but will serve the following functions:

- (1) Gathering information about the insurance industry, conducting studies on the industry, and generating reports for Congress and Executive Branch
- (2) Locating regulatory gaps and other issues in the insurance industry that may contribute to systemic risk
- (3) Administering the Terrorism Risk Insurance Program
- (4) Monitoring minority and other underserved communities' access to affordable insurance
- (5) Make recommendations to the Financial Stability Oversight Committee (also created by the Act) that particular insurers be supervised as a nonbank financial company by the Federal Reserve
- (6) Coordinate the Federal response to international insurance related matters, and
- (7) Negotiate international trade agreement that preempt inconsistent state regulations.

The FIO is granted the power to consult with state regulators in carrying out these functions.

### ***Mandated Studies***

The Act requires the newly formed FIO to conduct a series of comprehensive studies of the insurance industry and provide Congress with recommendations on how to modernize insurance regulation in the United States. Among other topics, the studies will weigh the costs, benefits, and feasibility of Federal regulation of the insurance industry.

### ***Information Gathering***

The FIO will have the power to require insurers and their affiliates to submit data to it as needed for the FIO to carry out the functions mandated by the Act. However, the Office's information gathering power will not extend to small insurers. The FIO's information gathering power includes the power to subpoena information from insurers. Before the FIO is permitted to gather data directly from insurers or subpoena them for information, it is required by the Act to determine whether the information is available from other sources, such as federal agencies, state regulators or other public sources. In conducting its information gathering function, the FIO is empowered to enter into information-sharing agreements with state regulators.

### ***Future Federal Regulation of Insurance?***

Although the FIO is not given regulatory authority by the Wall Street Reform Act, the studies mandated by the Act are telling. By studying the industry as a whole and the practicability of federal regulation of insurance, the feds are signaling their increased interest. And given the role of insurance companies like AIG in the financial crisis, it would be naïve to think that the FIO studies will find that federal regulation of insurance companies is absolutely unnecessary. Although comprehensive federal regulation of insurance may not be coming anytime soon, more federal involvement in the insurance industry is inevitable.

## The Wall Street Reform Act Streamlines Surplus Lines

The Wall Street Reform Act streamlines the regulation of surplus lines by making the insured's home state the sole regulator and tax collector in surplus lines transactions. "The National Association of Professional Surplus Lines Offices (NAPSLO) called the non-admitted industry and their broker representatives "big winners" in the financial services reform," reports National Underwriter Property and Casualty.<sup>21</sup>

Surplus lines producers are allowed to procure policies from out-of-state insurers who are not licensed in the producer's state and generally serve customers trying to insure a risk that in-state insurers are unwilling to insure. Because transactions in surplus lines policies involve multiple states—including at least the purchaser's home state and the insurer's home state—compliance nightmares and double taxation of premiums can make the process inefficient and unnecessarily complex.

The Wall Street Reform Act gives states until July 21, 2011 to implement the new law. As reported in National Underwriter, Property and Casualty, the NAPSLO executive director "explained that the full promise of this legislation will not be realized until the states have implemented through an interstate compact or similar mechanism uniform forms, processes and procedures for collection, payment and allocation of surplus lines premium tax."<sup>22</sup> NU is reporting that the insurance industry is actively involved in efforts to implement the legislation. The American Association of Managing General Agents explains that they "continue with the second phase of moving this from legislation to implementation through the Surplus Lines Insurance Multistate Compliance Compact which the industry has been working on with all state regulators and the AAMGA member surplus line and stamping offices."<sup>23</sup>

"Currently, the majority of states require payment of an allocated portion of tax on a multistate risk, but several state statutes impose the tax on the entire gross premium of a multistate risk which can create a 'double tax' on a portion of the premium in some transactions."<sup>24</sup> But under the Reform Act, only a customer's home state may collect a premium tax on nonadmitted policies. States with an interest in taxing interstate surplus lines transactions are permitted by the Act to develop procedures for allocating tax revenue collected by the customer's home state among themselves, but premiums will be paid directly to only one state. The Act anticipates that states will develop "uniform requirements, forms, and procedures... for the reporting, payment, collection, and allocation of premium taxes for nonadmitted insurance."

Prior to the Wall Street Reform Act, surplus lines transactions were weighed down by multi-state regulatory and documentation requirements. The Act changes that by making brokers accountable to only one regulator—the customer's home-state regulator. NU notes that the Act "will make access for insurance consumers to the surplus lines market quicker, more efficient and the payment of surplus lines premium taxes to the states less burdensome for the consumer and broker."<sup>25</sup>

In general, states require surplus lines producers to determine whether a risk can be insured by an admitted insurer before looking to nonadmitted insurers. The Act eliminates this requirement for some commercial purchasers. A surplus lines producer is permitted by the Act to look immediately to nonadmitted insurers to insure a large commercial purchaser's risk if the commercial purchaser employs a "qualified risk manager" and has paid property and casualty insurance premiums of at least \$100,000 in the preceding 12 months. Qualified risk managers must satisfy particular education and experience requirements.

---

<sup>21</sup> National Underwriter Property and Casualty, Surplus Lines Industry Says It Is 'Big Winner' In Fin Reform Bill (7/16/2010), <http://www.property-casualty.com/News/2010/7/Pages/Surplus-Lines-Industry-Says-It-Is-.aspx>

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

Taken together, the surplus lines provisions of the Act will increase efficiency in the surplus lines business. The Wall Street Reform Act's surplus lines provisions benefit insurers, surplus lines producers and their customers by introducing uniformity and single-state taxation of surplus lines transactions. Customers with hard-to-insure risks will have an easier time finding policies that fit their needs and may even save some money in the process.

## Fewer Clients Qualify for Performance-Based Fees

The Wall Street Reform Act reduces the pool of clients who can be charged performance-based fees. Currently, “qualified clients” can be charged performance fees if they have at least \$750,000 in funds under management, or a net worth of over \$1,500,000. The Reform Act requires that the SEC adjust these funds under management and net worth threshold amounts to account for inflation starting on July 21, 2011, and then index them for inflation every five years thereafter.

The Act requires that any adjustment be in increments of \$100,000, so the minimum upward adjustment permitted by the Reform Act is \$100,000. But because the threshold amounts were last adjusted for inflation in 1996, the new amounts will likely be appreciably higher than \$100,000. If the last adjustment in 1996 is any indicator, the new funds under management test will be at least \$1,000,000 and the net worth test will probably fall at about \$2,000,000, although the numbers could be adjusted higher or lower depending on how the SEC calculates inflation.

Any adjustment to the qualified clients test will reduce the pool of clients who can be charged performance-based fees. Advisors who charge performance-based fees will need to review how many clients fall close to current threshold net worth or funds under management, and should expect the new limits to force them to charge these clients differently in the future. While simply inflation indexing, the changes will force many advisors to re-examine their revenue streams and evaluate the services they can provide to impacted clients.

**For a sample client letter explaining the impact of this redefinition of “qualified client,” log onto [AdvisorFX.com](http://www.advisorfx.com).**

**AdvisorFX** is the online tool that puts a wealth of tax, sales, and strategic expertise at your fingertips. To find out how **AdvisorFX** will help you attract new clients, grow your business, and serve more markets, visit <http://www.advisorfxinfo.com>