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REGISTRATION AND EXEMPTION OF CROSS-BORDER INVESTMENT ADVISERS REVISITED

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A Summary Analysis of the Regulatory Thresholds for U.S. Investment Adviser Laws That Will Apply to Foreign Financial Advisors in 2012

As a result of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 and the adoption by the U.S. Securities and Exchange Commission (SEC) of related transitional rules in 2011, the regulatory thresholds for foreign financial advisors who offer their services in the U.S. are dramatically different in 2012. Through a series of focused questions and answers, this memorandum will provide an overview of the application of U.S. investment adviser laws to the operations of foreign financial advisers who expect to offer their services in the U.S. in 2012.

1. What financial advisory activities are regulated under U.S. law?

The federal Investment Advisers Act of 1940 (Advisers Act) and the rules and regulations of the SEC are the principal source of regulation for financial advisers in the U.S. The Advisers Act regulates anyone who is an investment adviser as defined under the act. Accordingly, an analysis of the application of U.S. regulation to persons who provide financial services in the U.S. begins with the definition of the term "**investment adviser**" under the Advisers Act.

An investment adviser is any person who:

- for compensation engages in the business of
- advising others, either directly or through publications or writings,
- as to the value of securities or as to the advisability of investing in, purchasing, or selling securities.

The term also includes any person who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

Generally, the SEC has broadly interpreted the concept of "engaging in the business of advising," so that if a person gives financial advice on a basis that constitutes a business activity, and if the adviser provides the advice with some regularity, then the adviser is considered to be engaging in the business. The frequency of the

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activity is viewed as a factor but is not determinative. For the purpose of determining the kind of financial advice that creates investment adviser status, the staff of the SEC has stated that it is sufficient if the adviser gives general advice about the value of securities, such as market timing advice. The advice does not have to be about specific securities.

References: Advisers Act section 202(a)(11); Investment Advisers Act Release No. 1092 (October 8, 1987).

2. When do cross-border investment advisory activities become subject to U.S. regulation?

The Advisers Act makes it unlawful for any investment adviser, unless registered or exempted from registration, to make use of any U.S. jurisdictional means (i.e., the U.S. mail or any means or instrumentality of interstate commerce) in connection with giving investment advice. Thus, a foreign investment adviser is literally required to be registered under or specifically exempted from registration under the Advisers Act whenever it uses a jurisdictional means, even if it does so in order serve its foreign clients. Nevertheless, the staff of the SEC has interpreted the Advisers Act so as to regulate the activity of foreign advisers only where their advisory conduct occurs within the U.S. or where their activity outside the U.S. produces substantial effects within the U.S. The U.S. is not viewed as having a significant regulatory interest in a relationship that involves neither clients nor advisory services within its borders.

Under this conduct and effects theory, the Advisers Act does not govern the relationship between a foreign adviser and its clients that reside outside the U.S. The staff of the SEC has also generally taken the position that registration is not required where a foreign adviser uses a jurisdictional means solely to obtain research or to place orders for securities with U.S. registered brokers but does not use a jurisdictional means to solicit clients or give investment advice.

Under this approach if a foreign investment adviser uses a jurisdictional means to give investment advice from within the U.S. to foreign clients, or if a foreign investment adviser uses a jurisdictional means to give investment advice to clients within the U.S., then the Advisers Act will apply.

References: Advisers Act section 203; Division of Investment Management, U.S. Securities and Exchange Commission, *Protecting Investors, a Half Century of Investment Company Regulation*, 227 (1992); Uniao de Bancos Brasileiros S.A. (Pub. avail. July 28, 1992).

3. Will an exemption or exclusion from U.S. federal investment adviser registration requirements apply if the financial adviser limits the services it provides in the U.S.?

For foreign financial advisers who provide limited services as investment advisers in the U.S., the principal registration exemption that may apply is the exemption for foreign private advisers, which exempts any investment adviser that:

- Does not hold itself out generally to the public in the U.S. as an investment adviser;

- Does not have a place of business in the U.S.;
- Advises, in total, fewer than 15 clients and investors in "private funds" (see question four, below) in the U.S.;
- Has aggregate assets under management attributable to clients in the U.S., and investors in the U.S. in private funds advised by the investment adviser, of less than $25 million; and
- Does not act as an investment adviser to an entity that is registered as an investment company or that has elected and maintained business development company status under the Investment Company Act of 1940 (Investment Company Act).

There are also exclusions from the registration requirements of the Advisers Act that apply when the provision of investment advice is solely incidental to the performance of professional services by certain persons, such as lawyers, accountants, and brokers or dealers in securities. Generally, for investment advisory services to be considered solely incidental to these other activities, the adviser must be principally engaged in one of these other activities, and the adviser may not charge a separate fee for the investment advisory services provided.

With regard to advisers who may be investment advisers because they publish analyses or reports regarding securities, there is an exclusion from the investment adviser definition for persons who are publishers of a bona fide newspaper, news magazine, or business or financial publication of general and regular circulation. This exclusion has generally been interpreted to require that the publication only provide impersonalized advice and disinterested commentary (i.e., not promotional material), and that it be of general and regular circulation (i.e., not timed to activity in the securities market).

References: Advisers Act sections 2(a)(11), (29), and (30), and 203A; Lowe v. SEC, 472 U.S. 181 (1985).

4. For purposes of the foreign private adviser exemption, what is a "private fund" and how is the less than 15 investor limit applied?

A private fund is defined as an issuer that would be an investment company (that is, a company that is in the business of investing in securities) under the Investment Company Act but for:

- The exclusion contained in section 3(c)(1) of the Investment Company Act (which generally excludes any investment company whose outstanding securities are beneficially owned by not more than 100 persons and that does not make a public offering of its securities); or
- The exclusion contained in section 3(c)(7) of the Investment Company Act (which generally excludes any investment company that is exclusively owned by "qualified investors" [i.e., very high net worth investors] and that does not make a public offering of its securities).

The foreign private adviser exemption, which went into effect on July 21, 2011, counts only the number of U.S. clients and U.S. investors in private funds, and the amount of their assets under management, against the thresholds for the exemption. Thus, for the purpose of determining whether they qualify for the exemption, a foreign private adviser may have an unlimited number of foreign clients or foreign investors in funds they advise, and neither the foreign clients nor the foreign

investors will count against the less-than-15 threshold, and neither the assets of the foreign clients they manage nor the assets of foreign investors in private funds they manage will count against the amount of assets they will be deemed to have under management.

Note, however, that foreign advisers to private funds that were established prior to July 21, 2011 (at a time when they may have relied on the former private adviser exemption, which only counted the numbers of clients for purposes of that exemption) are now subject to the provisions of the new private foreign adviser exemption, and that to the extent that they have U.S. investors and U.S. funds under management after that date, they may become subject to registration requirements.

Accordingly, foreign advisers must consider their current status not only in connection with new private funds being sold in U.S. but also in connection with existing private funds that they may have managed for many years without previously needing to be registered. Foreign advisers that were relying on the private adviser exemption on July 20, 2011 (when it ceased to be in effect) and that are thereafter unable to qualify for the foreign private adviser exemption are subject to a transition rule that allows them to delay registering with the SEC until March 30, 2012 (subject to the need to file a Form ADV with the SEC not later than February 14, 2012 so that the registration will become effective not later than March 30, 2012).

References: Advisers Act sections 2(a)(29), (30); Rules 202(a)(30)-1, 203-1(e).

5. Apart from the private foreign adviser exemption, what are the key exemptions from investment adviser regulation that may apply to foreign investment advisers?

The Private Fund Adviser Exemption

Separate from the private foreign adviser exemption, there is an exemption for advisers to private funds that can have special application to non-U.S. investment advisers. This private fund adviser exemption applies to any investment adviser that:

- Has no client in the U.S. other than one or morequalifying private funds (see question four, above); and
- Has no assets managed by the adviser at a place of business in the U.S. that are not solely attributable to private fund assets, the total of which is less than $150 million.

The private fund adviser exemption provides that for non-U.S. advisers, which are advisers that have their principal office and place of business outside of the U.S., the less-than-$150 million of assets under management requirement applies only to funds that are managed from a place of business in the U.S.

Because the private fund adviser exemption permits a non-U.S. adviser to have a place of business in the U.S. (although not its principal office and place of business) and manage up to $150 million of qualified private fund assets at its place of business in the U.S., the exemption provides flexibility in some areas where the foreign private adviser exemption does not. Note, however, that non-U.S. private fund advisers who rely on the private fund adviser exemption must avoid having <u>any</u>

U.S. clients that are not private funds.

The Venture Capital Fund Adviser Exemption

The Dodd-Frank Act and the rules of the SEC provide an exemption from registration under the Advisers Act for investment advisers that solely advise venture capital
funds. A venture capital fund is a private fund that:

- Holds at the time of acquisition of any asset no more than 20 percent of its total capital (as defined) in non-qualifying investments (generally, qualifying investments include equity securities issued by qualifying venture capital portfolio companies);
- Represents to its investors that it pursues a venture capital strategy;
- Does not borrow or otherwise incur leverage in excess of 15 percent of total capital, and any such borrowing is for a term of no longer than 120 calendar days;
- Does not offer redemption or liquidity rights to its investors except in extraordinary circumstances; and
- Is not registered under the Investment Company Act and has not elected business development company status under the Investment Company Act.

A non-U.S. adviser (i.e., an adviser whose principal office and place of business is outside of the U.S.), may only rely on the venture capital fund exemption if it solely advises funds that are venture capital funds. An adviser may treat as a private fund for purposes of the venture capital fund exemption any non-U.S. fund that is not offered in the United States but that would be a private fund if it were offered in a private offering in the U.S. If the adviser does so, it must treat the foreign fund as a private fund for all purposes of the Advisers Act. A non-U.S. adviser may not rely on the venture capital fund exemption if it advises any clients that are not venture capital funds, even if the clients are outside of the United States.

"Exempt Reporting Adviser" Status of Advisers That Rely on the Private Fund Adviser or Venture Capital Fund Adviser Exemptions

SEC rules characterize advisers who rely on either the private fund adviser exemption or the venture capital fund adviser exemption as exempt reporting advisers, and the rules require "exempt reporting advisers" to file annual reports consisting of an abbreviated version of the registration form filed by registered investment advisers. Generally, exempt reporting advisers must file the information required by the following sections of Part 1 of Form ADV: Item 1 (Identifying Information); Item 2.B (SEC Reporting by Exempt Reporting Advisers); Item 3 (Form of Organization); Item 6 (Other Business Activities); Item 7 (Financial Industry Affiliations); Item 10 (Control Persons); Item 11 (Disclosure Information); and corresponding sections of Schedules A, B, C and D. Exempt reporting advisers are required to pay filing fees similar to those paid by registered advisers.

Regulatory Assets Under Management Computations for Exempt Reporting Advisers

The SEC has adopted rules for the uniform computation of regulatory assets under management (AUM), which apply to advisers who file Form ADV, including both exempt reporting advisers and registered investment advisers. Generally, AUM for reporting purposes includes:

- The value of securities portfolios as to which the adviser provides continuous and regular supervisory or management services, including securities portfolios of non-U.S. clients if they are managed from the United Sates;
- The value of the assets of any private fund over which an adviser exercises continuous and regular supervisory or management services;
- The amount of any uncalled capital commitments for any private fund; and
- The value of any proprietary accounts or other accounts for which the adviser receives no compensation.

Note that although the provisions for uniform computation of regulatory assets under management applies to AUM to be used by investment advisers that report to the SEC, the SEC's implementing release concerning AUM implies that it does not apply to the determination of whether assets should be considered under management for the purpose of determining whether an advisor is an investment adviser. Managing accounts without compensation is not consistent with being in the business of providing advice as to the value of securities (see question 1, above).

Transition Aspects of Exempt Reporting Adviser Status

Exempt reporting advisers (i.e., advisers that rely on either the private fund adviser exemption or the venture capital fund adviser exemption) must file an annual report on Form ADV containing limited disclosures (see question five, "Exempt Reporting Adviser Status of Advisers…," above) after January 1, 2012 and not later than March 30, 2012.

References: Advisers Act sections 203(l), 203(m); Rules 203(l)-1 and 203(m)-1; General Instructions to Form ADV; Release IA-3221 (June 22, 2011); Release No. IA-3222 (June 22, 2011).

6. If a foreign investment adviser must register under the Advisers Act, what kinds of regulations will apply to its operations?

If a foreign financial adviser acts as an investment adviser in the U.S., and if it is not exempted or excluded from registration, then it must register by filing a Form ADV with the SEC. Form ADV is filed over the Internet through the IARD electronic registration system. Form ADV requires information about the adviser's business, the persons who own and control the adviser, its business practices, the fees it charges, and the potential conflicts of interest that the adviser may have with its clients. A description of the registration and filing process is available on the SEC's website at www.sec.gov/divisions/investment/iard/register.shtml.

Generally, the SEC must either declare an investment adviser registration effective within 45 days after the Form ADV is filed, or it must take affirmative action to prevent the registration from becoming effective. Registrations usually become effective within a few weeks. The adviser may check through the IARD system to determine when the registration has become effective, and the SEC will deliver an order granting effectivemess to the adviser by e-mail when registration is

complete.

After the registration becomes effective, the adviser will be subject to a range of substantive regulatory requirements including requirements for:

- Amending and updating Form ADV;
- Limiting advertising and referral fees;
- Providing disclosure documents about the adviser to clients;
- Using appropriate written investment advisory contracts with clients;
- Maintaining certain books and records;
- Limiting the use of performance based fees;
- Meeting custody standards for securities and funds;
- Restricting trading in securities including principal and agency cross limitations;
- Maintaining a code of ethics and privacy policies; and
- Maintaining a compliance program that includes written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act.

A general overview of these requirements is provided by an SEC staff memorandum titled "Information for Newly-Registered Investment Advisers," which can be found at www.sec.gov/divisions/investment/advoverview.htm.

The SEC undertakes periodic, special and other examinations of the books and records of federally registered investment advisers. The SEC's goal is to complete an initial inspection during the first year of the adviser's registration and to make at least one inspection during each four-year period thereafter. Generally, the timing and frequency of inspections is related to the degree of risk associated with the kinds of operations in which the adviser engages. In the case of registered investment advisers that maintain their offices outside of the U.S., the adviser must be prepared to deliver complete copies of its required books and records to the SEC in connection with any examination.

The Advisers Act preempts state registration of federally registered investment advisers by prohibiting any state or political subdivision of a state from requiring the registration, licensing, or qualification of an investment adviser or supervised person of an investment adviser that is registered with the SEC. States do have the right to require federally registered investment advisers to provide them with copies of any filings made with the SEC and the right to receive filing and licensing fees. Generally, these notice requirements can be accomplished through checking the appropriate boxes on Form ADV filed through the federal IARD electronic filing system.

References: Advisers Act sections 203, 203A, and 222; Rule 203A-1.

7. If a foreign investment adviser is registered under the Advisers Act, what kinds of regulations will apply to the natural persons who act as the adviser's representatives?

Although the Advisers Act generally preempts any state registration, qualification, or licensing for the supervised persons of federally registered investment advisers, the states are permitted to regulate any person who comes under the definition of an "investment adviser representative." Generally, an investment adviser representative is a supervised person of an investment adviser who has an office within the state, if the representative has as clients more than five natural persons within the state, and if more than 10 percent of the representative's clients are natural persons (in each case, any natural person who has at least $1 million under management or who has a net worth of more than $2 million is not counted as a client). Notwithstanding the general definition of an investment adviser representative, the SEC has specifically excluded from investment adviser representative status those supervised persons who do not on a regular basis solicit, meet with, or otherwise communicate with clients of the investment adviser and those supervised persons who provide only impersonal investment advice.

Some states, such as New York, do not have separate qualification requirements for investment adviser representatives of federally registered investment advisers. Many states do have separate requirements for investment adviser representatives of federally registered investment advisers, typically including requirements for the investment adviser representatives to:

- Pass either the Uniform Investment Adviser Law Exam (series 65), or pass both the General Securities Representative Examination (series 7) and the Uniform Combined State Law Examination (series 66), or be exempt from the examination requirement by being a member of a recognized, credentialed professional advisory organization, such as a certified financial planner (CFP), chartered investment counselor (CIC), chartered financial consultant (ChFC), personal financial specialist (PFS), or chartered financial analyst (CFA);
- File a Form U-4 representative application; and
- Pay required filing fees.

References: Advisers Act section 203A; Rule 203A-3; www.nasaa.org/1325/adopted-model-rules/ (last visited 10/11/11).

8. If a foreign investment adviser is not required to register under the Advisers Act, will it be required to register by individual states within the U.S.?

As discussed above, the Advisers Act generally requires foreign investment advisers to register federally if they have 15 or more clients within the U.S. during any 12-month period, if they have more than $25 million of AUM, or if they hold themselves out to the public as offering investment advisory services. The Adviser's Act also contains a national de minimis standard, which prohibits the states from requiring investment advisers to register or comply with qualification or licensing requirements (other than provisions prohibiting fraudulent conduct) if they do not have a place of business within the state and if during the preceding 12-month period they had fewer than six clients who are residents of the state.

Thus, foreign investment advisers who provide advisory services in the U.S. become subject to state registration requirements if their activities place them within the narrow window between the lower limit for federal registration (having fewer than 15 clients within a 12-month period, having less than $25 million AUM, and not holding themselves out to the public as investment advisers) and the national de minimis standard for state registration requirements (having more than five clients within a 12-month period and having an office within the state).

References: Advisers Act sections 203A(b)(1) and 222(d).

9. If a foreign financial adviser must register as an investment adviser under state law, what kinds of regulations will apply to its investment advisory activities?

Each of the states (except Wyoming), the District of Columbia, and Puerto Rico, have registration or licensing requirements for investment advisers, which apply to any investment adviser that acts as an investment adviser within its jurisdiction and is not exempted by the national de minimis standard. Generally, registration within a state is accomplished by:

- Filing a Form ADV with the state;
- Providing any state-specific forms required; and
- Paying required registration fees.

In most cases, filing is accomplished through the IARD electronic filing system that is used for federal registration filings. For an overview of substantive requirements applicable to state registered investment advisers, see www.nasaa.org/industry-resources/investment-advisers/investment-adviser-guide/ (last visited 10/11/11).

Many states have regulations relating to one or more of the following topics: required disclosures to clients, custody, maintenance of books and records, advertising, bonding, and minimum net capital. If an investment adviser is registered in the state in which it maintains its principal office, a dual compliance provision of the Advisers Act prohibits any other state from imposing registration or qualification standards on the state registered adviser that are more restrictive than the requirements of the adviser's state of registration with respect to: the maintenance of books and records, net capital requirements, or bonding requirements. Since foreign investment advisers may have an office within a state but will not have their principal office and place of business within any state, there may be situations in which a foreign investment adviser, which might be required to register in one or more states but not federally, would choose to register federally in order to avoid being subject to multiple state record keeping, net capital, or bonding requirements.

Although the Advisers Act relegates to the states the primary responsibility for investment advisers who are not required to register federally, it nevertheless includes a number of provisions that apply to both federal and state registered investment advisers. These provisions include:

- Requirements for advisers to maintain proceduresreasonably designed to prevent misuse of material non-public information by the adviser and its associated persons in violation of the Securities Exchange Act;

- Requirements governing the provisions contained in advisory contracts with clients relating to performance fees, assignment of any advisory contract, and notification of change in the membership of the adviser if it is organized as a partnership;
- Restrictions on the collection of performance fees; and
- Prohibitions on fraud and restricting agency cross and principal transactions.

References: Advisers Act sections 222, 204A, 205, 206; Rules 222-1 and 2, and 205-1, 2 and 3.

10. If a foreign investment adviser registers as an investment adviser under state law, what kinds of regulations will apply to the natural persons who act as its representatives?

Except where they are subject to federal preemption (see question six, above), the individual states may impose licensing and qualification requirements not only on investment advisers but also on investment adviser representatives. Generally, where states require registration or qualification of investment adviser representatives of state registered investment advisers, they require the investment adviser representatives to:

- Pass either the Uniform Investment Adviser LawExam (series 65), OR pass both the General Securities Representative Examination (series 7) and the Uniform Combined State Law Examination (series 66), OR be exempt from the examination requirement by being a member of a recognized, credentialed professional organization such as a certified financial planner (CFP), chartered investment counselor (CIC), chartered financial consultant (ChFC), personal financial specialist (PFS), or chartered financial analyst (CFA).
- File a Form U-4 representative application in conjunction with adviser's Form ADV; and
- Pay required filing fees.

References: For an overview of substantive requirements applicable to state registered investment advisers, see www.nasaa.org/industry-resources/investment-advisers/investment-adviser-guide/ (last visited 10/11/11).

11. If a foreign investment adviser is not required to register under the Advisers Act or under state investment advisers laws, what regulations will apply to its investment advisory activities in the U.S.?

In situations where an adviser is exempt as a foreign private adviser and where the states are preempted from imposing registration and qualification standards on investment advisers, the national de minimis standard contained in the Advisers Act nevertheless permits the states to prohibit fraudulent conduct. The Advisers Act also imposes certain requirements on all investment advisers, whether or not they are required to be registered or qualified by the SEC or any state. These

provisions make it unlawful for any investment adviser to engage in:

- Any device or scheme to defraud clients or prospective clients;
- Any practice which operates as a fraud on any client or prospective client;
- Certain undisclosed principal or agency cross transactions; and
- Any act, practice, or course of business which is fraudulent, deceptive, or manipulative.

References: Advisers Act sections 222, 204A, and 206; Rules 206(3)-1, 206(3)-2, and 206(3)-3.

12. If a foreign investment adviser is considering engaging in investment advisory activities in the U.S., what is the next step?

The foregoing discussion should enable a foreign investment adviser to form a general understanding of the level of regulatory oversight that applies to foreign investment advisers and to their supervised persons depending upon whether they will be required to register federally with the SEC, register with a state in which they will maintain an office, or operate below the threshold of the national de minimus standard. If the adviser determines to proceed with its proposed U.S. activities, the next step would be to work with appropriate legal counsel to develop a comprehensive compliance program tailored to the specific operations that the adviser will undertake.