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A Look At Regulations For Non-U.S. Investment Advisers And Portfolio Managers Doing Business In The United States

Benjamin J. Catalano and Kathy H. Rocklen

PROSKAUER

Benjamin J. Catalano

Kathy H. Rocklen

This article discusses the U.S. registration and regulatory issues arising from the provision of discretionary portfolio management or other investment advisory services by non-U.S. advisers[1] to clients in the United States.[2]

I. Jurisdiction and Exemptions from Federal and State Registrations

Section 203(a) of the U.S. Investment Advisers Act of 1940 (the "Advisers Act" or the "Act") prohibits an investment adviser[3] from making use of the mails or any means or instrumentality of interstate commerce (jurisdictional means) in connection with its business as an investment adviser unless the adviser is registered with the U.S. Securities and Exchange Commission ("SEC" or the "Commission") under the Advisers Act or qualifies for an exemption from registration.

Prior to the promulgation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which has amended the law with respect to federal registration of investment advisers, the most widely used exemption from registration was the so-called "Private Adviser Exemption," which exempted from registration any investment adviser who (1) during the preceding 12 months had fewer than 15 clients, (2) did not hold itself out generally to the public as an investment adviser, and (3) did not advise any investment company registered under the U.S. Investment Company Act of 1940 (the "Investment Company Act") or any registered business development company.[4] In general, under this historical exemption, a fund or other partnership, corporation or legal organization qualified as a single client for purposes of the exemption. There was no need to look through a fund to count its underlying investors.[5] As a result, an adviser could advise up to 14 private funds, regardless of the total number of investors invested in the funds or the amount of assets of the funds, without having to register with the SEC. An adviser with its principal office and place of business outside the United States was not required to count its non-U.S. clients toward the 15-client threshold.[6]

The Private Adviser Exemption has been repealed by the Dodd-Frank Act.[7] As a consequence, non-U.S. advisers that have U.S. investors in their funds, manage fund vehicles established in the United States, or have a presence in the United States are potentially subject to registration in the United States.[8] While the primary purpose of the U.S. Congress in repealing the Private Adviser Exemption was to require advisers to private funds to register, Congress created three more limited exemptions from investment adviser registration.

***Benjamin J. Catalano** and **Kathy H. Rocklen** are Partners in the Corporate Department at Proskauer and Co-Heads of the firm's Broker-Dealer & Investment Management Regulation Group. **John R. Braatz,** former Special Financial Services Counsel in the firm's Litigation Department, and **Alice Dullaghan**, an Associate in the firm's Corporate Department, assisted in the preparation of this article. Please visit http://www.metrocorpcounsel.com/articles/18807/look-regulations-non-us-investment-advisers-and-portfolio-managers-doing-business-uni for the footnotes to this article.*

Please email the authors at bcatalano@proskauer.com or krocklen@proskauer.com with questions about this article.

The "Foreign Private Adviser Exemption" exempts an investment adviser that (1) has *no* place of business in the United States, (2) has fewer than 15 clients and investors in the United States in private investment funds advised by the adviser, (3) has less than US$25 million in assets under management attributable to clients and investors in the United States, and (4) does not hold itself out generally to the public in the United States as an investment adviser, or act as investment adviser to a registered investment company or registered business development company.[9] The Foreign Private Adviser Exemption is significantly narrower than the Private Adviser Exemption in that, along with the very limited asset threshold, it requires the adviser to look through a private investment fund client and count any U.S. investors in the fund towards the fewer than 15 U.S. clients and investors limit set forth in part (2) of the test, although the adviser does not have to double-count the private investment fund as a "client" for this purpose. An adviser relying on the Foreign Private Adviser Exemption is not required to make any filing with the Commission.

The "Private Fund Adviser Exemption" exempts from SEC registration an investment adviser that (1) acts as an adviser *solely* to private funds and (2) has assets under management in the United States of less than US$150 million.[10] For purposes of part (1) of the test, a non-U.S. adviser may avail itself of the exemption as long as all of its clients that are United States persons are private funds.[11] For purposes of part (2) of the test, a non-U.S. adviser may engage *from the United States* in day-to-day management of fund assets not exceeding US$150 million in the aggregate without becoming subject to registration.[12] Accordingly, the non-U.S. adviser's non-U.S. clients will not count in determining its status as a manager of private funds alone provided the assets of such non-U.S. clients are not managed from within the United States. However, if the non-U.S. adviser manages assets for U.S. clients that are not private funds (e.g., separately managed accounts), or assets of foreign clients that are not private funds from the United States, then the exemption is not available. If a non-U.S. adviser has no place of business in the United States, it can operate under the exemption regardless of the number of U.S. investors in its funds or the amount of assets attributable to those investors.[13] A U.S. resident adviser may not avail itself of the exemption if it provides advice to clients other than private funds (whether or not resident in the United States).[14] An adviser relying on the Private Fund Adviser Exemption will be deemed to be an "exempt reporting adviser."[15]

The third exemption from registration, the "Venture Capital Fund Exemption," is available to advisers solely to venture capital funds.[16] A "venture capital fund" is defined as a private fund that (1) represents itself to investors as pursuing a venture capital strategy, (2) invests primarily in "qualifying investments,"[17] (3) is not leveraged except for a *de minimis* amount of short-term debt, and (4) does not offer redemption rights to investors.[18] Like the Private Fund Adviser Exemption, advisers relying on the Venture Capital Fund Exemption are considered "exempt reporting advisers" required to file certain reports with the Commission.[19]

If any of the foregoing exemptions are available, Section 222(d) of the Advisers Act[20] prohibits the states from requiring that the adviser register in the state if the adviser has no place of business in the state and it has had fewer than six clients who are state residents during the preceding 12 months. The states, however, retain investigatory and enforcement jurisdiction with respect to exempt advisers.

The new registration exemptions are not mandatory. An adviser that qualifies for any of these exemptions could, nevertheless, choose to register with the Commission, subject to Section 203A of the Advisers Act, which prohibits most advisers from registering with the SEC if they do not have at least $100 million in assets under management. Some advisers might choose to register in these circumstances to enhance their profiles in competing for U.S. mandates.

Non-U.S. advisers conducting advisory business in the United States that do not qualify for any of these exemptions, or who choose to register notwithstanding an available exemption, can structure their U.S. operations to minimize the U.S. regulatory impact on the non-U.S. adviser by establishing a separate U.S. advisory affiliate and registering it with the SEC under the Advisers Act. Organizational separation of the U.S. advisory activities provides a greater degree of insulation between the activities of the U.S. registrant and the non-U.S. adviser. This structure also provides greater flexibility in addressing any different or conflicting regulatory requirements that the United States may impose. The registration and other substantive provisions of the Advisers Act ordinarily should not apply beyond the separately organized U.S. registrant, while registering the non-U.S. adviser for its U.S. advisory business would subject the entirety of its global operations to U.S. regulatory requirements under the Act.[21] Larger, more complex foreign entities, especially those that have an expectation of expanding their operations in the United States, frequently organize a U.S. or foreign holding company with the registered entity as a subsidiary.[22] This provides a more flexible structure for a growing operation with multiple lines of business. The establishment of a U.S. advisory affiliate (with or without a holding company) should not preclude the U.S. registrant from making use of the personnel and other resources of its larger, non-U.S. affiliate in providing advisory services to U.S. clients, subject to certain limitations and qualifying conditions discussed below.

II. Investment Adviser Registration

If the non-U.S. adviser (or its affiliate) is required to register as a result of its U.S. business, it will be necessary to consider whether federal or state registration is appropriate.

A. Federal or State Registration

The regulation of investment advisers is apportioned between the SEC and the states. In general, if an adviser manages more than US$100 million in assets it must register with the SEC, but not with the states, subject to a number of exceptions including a non-U.S. adviser with its principal office and place of business outside the United States.[23] The Advisers Act includes provisions governing the conduct of many aspects of an adviser's business, and it provides the SEC with oversight, inspection and disciplinary authority over the registered adviser.

Most states require registration for advisers doing business in the state that are not subject to register with the Commission.[24] The state will have oversight, inspection and disciplinary authority under the state's Blue-Sky laws that is similar to the SEC under the Advisers Act, although there are exceptions and variations from state to state. While the states are precluded from applying their registration and licensing laws to advisers registered under the Advisers Act,[25] they may require notice filings and payment of annual fees for federally registered advisers doing business in the state, and, furthermore, retain the authority to investigate and bring enforcement actions against advisers for fraud.[26] In addition, the states are not precluded from imposing registration, licensing and qualification requirements on "investment adviser representatives" with a place of business in the state,[27] and most states do in fact impose such requirements.

Application for registration as an investment adviser at the federal level is made on Form ADV. Form ADV is filed with the SEC and must be updated on an annual basis. Many states also permit advisers to register using Form ADV; however, they also may require additional forms and annual renewal of registration and payment of fees.

Form ADV consists of two parts, along with several schedules and disclosure reporting pages to be completed as necessary. Form ADV Part 1 provides for administrative information, including (1) the adviser's name, state of organization, and the locations of its principal place of business and offices, (2) ownership structure and controlling persons, (3) financial and operational information, (4) state registrations, (5) discretionary and nondiscretionary assets, (6) whether the adviser maintains custody of clients' assets, (7) disciplinary history, and (8) background information concerning personnel.[28]

Form ADV Part 2, known as the "adviser brochure," requires information that must be provided to clients and prospective clients, in narrative format, including, among other information, (1) a description of the adviser's business and the types of services offered, (2) fees and compensation, (3) types of clients, (4) investment strategies, (5) disciplinary information, (6) affiliations with other securities professionals, (7) a description of the adviser's code of ethics and whether the adviser participates in or has an interest in client transactions, (8) brokerage practices, (9) whether the adviser maintains custody of client funds or securities, has investment discretion, and has or will accept authority to vote client securities and, if so, a description of the adviser's voting practices, and (10) certain financial information about the adviser. The "brochure supplement" requires the adviser to set forth the background and qualifications of its investment professionals in a résumé-like disclosure, including any disciplinary history.

Advisers are required to file Parts 1 and 2 (except for the brochure supplement) electronically with the Commission.[29] The adviser brochure (including the brochure supplement) also must be delivered initially to clients and prospective clients and annually thereafter with respect to existing clients.[30] SEC-registered advisers not resident in the U.S. must file consent to service of process with the Commission.[31] Non-resident investment advisers also are required to file a notice with the SEC specifying an address within the U.S. where the adviser will maintain its books and records, unless the adviser files an undertaking to furnish copies of all such books and records to the Commission at the adviser's expense within 14 days.[32]

The SEC must take action to grant or deny registration as an investment adviser within 45 days after filing Form ADV.[33] Once granted, registration will cover the adviser's employees and other associated persons. The adviser's employees do not have to register individually with the SEC.[34]

While the adviser is awaiting the SEC's decision on its registration application, it should develop a "Compliance and Supervisory Procedures Manual" and a "Code of Ethics" tailored to its U.S. advisory business. These documents should address among other things, standards of conduct, managing conflicts of interest, preventing the misuse of inside information, personal trading activities, compliance with Advisers Act requirements, record keeping and reporting, supervision and surveillance.

B. SEC Relief for Registered Advisers Sharing Resources with non-U.S. Affiliates (The "Unibanco Letters")

In a series of no-action letters,[35] the staff of the Division of Investment Management of the SEC (the "Staff") has provided relief to registered non-U.S. advisers and their affiliated holding companies to allow them to make use of personnel and other resources of the unregistered companies in providing discretionary advisory services and portfolio management services to U.S. clients through the registered entity, often known as "dual hatting" arrangements.

The SEC has long taken the position that a registered investment adviser is subject to the substantive provisions of the Advisers Act with respect to *all* of its clients regardless of their location. Consequently, non-U.S. advisers have been reluctant to register in the U.S. out of concern that the Advisers Act would apply to their relationships with their non-U.S. clients. However, over the years the Staff has confirmed that a non-U.S. adviser may establish a separate, registered affiliate to conduct its advisory business in the United States, thereby limiting the application of the Advisers Act to the affiliate and avoiding direct regulation of the non-U.S. advisory business, provided the U.S.-registered affiliate has a separate and viable commercial existence.

In general, the SEC recognizes the independent existence of the affiliated entities if they are separately organized, the registered entity is staffed with personnel (located in the U.S. or abroad) who are capable of providing investment advice, any personnel of the non-registered entity involved in U.S. advisory activities are deemed "associated persons" of the registrant, and the Commission has adequate access to trading and other records of the affiliate and its personnel necessary to enable it to identify conduct that may harm U.S. clients or markets.[36]

In 1981, the Staff set out certain conditions for demonstrating the degree of "separateness" required of the U.S.-registered affiliates of non-U.S. advisers in a "no-action letter" issued to Richard Ellis, Inc. (sometimes referred to as the "Ellis conditions").[37] Some of the Ellis conditions, particularly the condition requiring separate investment advisory personnel, posed significant practical difficulties. Then, in 1992, the Staff announced a "conduct and effects" test that would apply the Advisers Act to non-U.S. advisers only if their activities take place in the United States or have a substantial and foreseeable effect in the United States or on U.S. persons.[38] The Staff also reaffirmed its basic position that independent entities would be considered separately. The Staff recommended a relaxation of the Ellis conditions. Specifically, it proposed to drop the requirement for a separate board of directors, and agreed to permit personnel and communications to be shared between the registrant and its non-U.S. affiliate. The relaxed approach requires that the registrant be staffed with qualified investment advisers.[39] A no-action letter issued to Uniao de Bancos de

Brasileiros S.A. on July 28, 1992, was the first in a series of no-action letters issued to non-U.S. advisers reflecting the Staff's application of the broader position (often referred to collectively as the "*Unibanco* letters"). The amendments to the Advisers Act contained in the Dodd-Frank Act do not affect the viability of the *Unibanco* letters.[40]

1. Uniao de Bancos de Brasileiros S.A.

The first in the series of no-action letters was Uniao de Bancos de Brasileiros S.A., July 28, 1992 ("*Unibanco*"). In *Unibanco*, the Staff expressly permitted a registered investment adviser subsidiary of a non-U.S. adviser to share advisory personnel with its unregistered parent, provided that the shared personnel were competent to advise clients appropriately and that the registrant was a separate legal entity.

The Staff's response included certain conditions to address its concern that the arrangement would not lead to abuses such as placing trades of non-U.S. clients ahead of U.S. clients or entering into unauthorized agency cross-transactions. The most significant of these conditions required the unregistered parent company to agree to maintain and make available to the SEC for inspection certain books and records pertaining to "related securities transactions." The parent company had to agree to make available to the SEC for testimony all persons engaged in the registered subsidiary's advisory operations. To ensure compliance with these undertakings, the parent had to appoint an agent in the United States to accept service of process for the production of documents and testimony. Separate assurance was given that the parent company would not be required to reveal the identities of its non-U.S. clients in connection with any such proceedings.

2. National Mutual Group

National Mutual Group, March 8, 1993 ("*National Mutual*"), dealt with a complex of several non-U.S. financial services companies that rendered investment advice to both U.S. and non-U.S. clients through the same entities. In *National Mutual*, the corporate structure consisted of the National Mutual Life Association of Australia ("National Mutual Life"), which, through certain holding companies, owned separate fund management companies in Europe, Asia and Australia (the "NMFM Companies"). Each of the NMFM Companies was subject to the regulations and licensing standards of its local jurisdiction. National Mutual Life also owned, indirectly, CMB Investment Counselors ("CMB"), a U.S. investment adviser registered under the Advisers Act.

CMB and the NMFM Companies wanted to provide investment advice directly to U.S. clients with regard to U.S. and foreign markets by allocating assets among CMB and the NMFM Companies. While the NMFM Companies were required to register under the Advisers Act, the Staff granted specific relief from certain recordkeeping, operational and administrative provisions of the Advisers Act with regard to the NMFM Companies' non-U.S. clients.[41] Any activities of the non-U.S. adviser and its personnel in relation to U.S. clients that fall within the jurisdictional scope of the Advisers Act would continue to be subject to the antifraud provisions under Section 206 of the Act.

3. Royal Bank of Canada

In *Royal Bank of Canada*, June 3, 1998, the proposed structure, like *Unibanco*, involved a separate subsidiary formed to advise U.S. clients that made use of personnel and resources of the non-U.S. parent. The Staff used the opportunity to reconsider certain undertakings previously articulated in *National Mutual* and *Murray Johnstone*, and noted that persons relying on these prior letters also would have to make "clerical and ministerial" personnel available for testimony or other questioning by the SEC or its staff upon receipt of an administrative subpoena, demand, or a request for voluntary cooperation made during a routine or special inspection. The Staff positions were based on certain representations and undertakings, which must be disclosed on Form ADV Part 2.

The *Unibanco* letters continue to provide the relevant guidance for structuring dual-hatting and other cooperative arrangements to enable an SEC-registered adviser to utilize the more expansive resources of its non-U.S. parent or affiliate in servicing its U.S. clients while limiting the extension of the Advisers Act to the latter's overseas operations.

The arrangement typically is implemented by entering into an agreement between the affiliates on the sharing of personnel and resources, and consents to provide information and records to the SEC by the non-U.S. adviser and its personnel involved in providing services to U.S. clients.

The U.S. adviser's written supervisory procedures should include specific protocols designed to effect compliance with the operational requirements and restrictions specified in the *Unibanco* letters. All dual-hatted employees are associated persons of the U.S. adviser. Therefore, all dual-hatted employees must comply with the firm's written supervisory procedures.[42]

The SEC-registered adviser also must make certain disclosures pertaining to the arrangement in its advisory brochure.