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SEC Finalizes Dodd-Frank Rules Affecting Non-U.S. Investment Advisers

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The Private Fund Investment Advisers Registration Act of 2010: The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which was signed into law July 21, 2010, effects changes to the Investment Advisers Act of 1940 (the "Act") that change the bases on which non-U.S. advisers will be subject to regulation by U.S. regulators. On June 16, 2011, the Securities and Exchange Commission ("SEC") released final rules to implement these provisions of Dodd-Frank (the "Adopting Release").[1]

What will change: Currently, non-U.S. advisers with fewer than 15 U.S. clients are generally exempt from registration and recordkeeping requirements under the Act.[2] Advisers to private funds can generally count each fund as a single client; thus, most private equity and hedge fund managers are able to rely on this exemption. Dodd-Frank repealed this so-called "private adviser exemption" and replaced it with, among other things, (a) a "***foreign private adviser exemption***," and (b) an exemption for advisers to private funds with aggregate assets under management of less than $150 million (the "***private fund adviser exemption***").

The Foreign Private Adviser Exemption

The Act. The new foreign private adviser exemption is embodied in amended § 203(b)(3) of the Act, and the definition of "foreign private adviser" is embodied in § 202(a)(30) of the Act and the new FPA Rule. Taken together, these statutory provisions exempt qualifying managers from SEC oversight completely-no registration is required and no reporting requirements or examination exposure apply. The exemption applies to an investment adviser that (i) has no place of business in the United States,[3] (ii) has a total of fewer than 15 (a) clients in the United States and (b) private fund[4] investors in the United States[5] , (iii) has assets under management attributable to such U.S. clients and private fund investors of less than $25 million,[6] and (iv) neither holds itself out generally to the U.S. public as an investment adviser nor acts as an investment adviser to a registered investment company or business development company. The SEC rejected jurisdictional arguments that non-U.S. advisers with no U.S. place of business and no U.S. clients are outside the jurisdiction of the Act based on those facts alone. The SEC reaffirmed that, under § 203(a), whether such an adviser is subject to registration depends on the adviser's use of U.S. instrumentalities of interstate commerce.[7]

The Rules. Given Dodd-Frank's repeal of the existing private adviser exemption, the SEC repealed a related rule, Rule 203(b)(3)-1, and adopted, in its place, Rule 202(a)(30)-1 (the "FPA Rule"). The FPA Rule defines certain terms and incorporates certain safe harbor and client counting guidelines of the rescinded rule.

The FPA Rule provides, on a safe harbor basis, that a foreign adviser may count as a single client any of (i) a natural person and his or her minor children, spouses and "spousal equivalents,"[8] other co-habiting relatives, accounts and trusts of which such persons are the "only primary beneficiaries"; (ii) a corporation, partnership, limited liability company, trust or other legal organization to which the adviser provides investment advice based on the legal organization's investment objectives; or (iii) two or more legal organizations having identical shareholders, partners, members or beneficiaries. The SEC also adopted provisions clarifying that advisers need not double-count private funds and their investors in determining eligibility for this exemption.[9] Advisers must count as "clients" persons to whom advisory services are provided without compensation.

Because the new exemption is based on counting investors as well as clients, the FPA Rule defines "investor" as any person who would be included in determining the number of beneficial owners of a private fund for purposes of compliance with § 3(c)(1) of the Investment Company Act of 1940, as amended (the "Company Act"), or in determining whether the outstanding securities of a private fund are owned exclusively by qualified purchasers under § 3(c)(7) of the Company Act, excluding "knowledgeable employees." By aligning with the Company Act's exemptions and "look-through" counting rules, the SEC stated that it hopes to promote consistent application of statutory provisions, avoid redundancy of compliance efforts, and limit the ability of non-U.S. advisers to circumvent the Act by setting up intermediate or nominee accounts.

The Adopting Release also articulates a few special rules and interpretations. First, alignment goals notwithstanding, a beneficial owner of short-term paper issued by a private fund is an "investor," notwithstanding that such owners are not counted for §,3(c)(1) purposes. This raises the question of whether a prime broker, a counterparty to a fund's reverse repo and any other creditor is an "investor." The Adopting Release states that not every lender to a private fund will be an investor. Only where the extension of credit to the fund results in the issuance of a security by the fund to its creditor would the creditor be considered an investor for purposes of the foreign private adviser exemption.[10] Second, seemingly for the avoidance of doubt, the Adopting Release reiterates an existing principle that the adviser to a master fund would have to treat as "investors," owners of feeder funds that were formed or operated for the purpose of investing in the master fund. It then goes on to say that an owner of a total return swap on a private fund would also count as an investor because the swap replicates the risks and rewards of investing in the fund. This is not intuitive because (i) third parties can create a total return swap without the knowledge of the adviser, and (ii) the issuer of the swap will probably invest directly in the fund as a hedge, so the fund is already counting that investor who has swapped away its fund risks and rewards. The Adopting Release addresses this by providing that an adviser may treat as an investor the person the adviser reasonably believes is the actual investor.[11] Also, query whether the owner of a swap, the terms of which alter the risk/reward profile, should be included or excluded from the investor count. Other derivatives may be similarly implicated. Finally, an adviser needs to count only once an investor that invests in multiple funds managed by the adviser.

The new law also involves determining whether places of business and client/investors are "in the United States." The FPA Rule defines "in the United States" (i) with respect to any place of business, any such place that is located in the "United States" as defined in Regulation S, and (ii) with respect to any client or private fund investor in the United States, any person who is a "United States Person" as defined in Regulation S, provided, however, that any discretionary or similar account held for the benefit of a "United States Person" by a non-U.S. dealer or fiduciary is deemed to be "in the United States" if the dealer or fiduciary is a related person of the adviser seeking to rely on the exemption. Furthermore, to mitigate the regulatory impact of migration, a person who is "in the United States" may be treated as not being in the United States if the person was not "in the United States" at the time of becoming a client, or in the case of a private fund investor, if the investor was not "in the United States" each time the investor acquired securities issued by the fund.

Private Fund Adviser Exemption

The Act: Non-U.S. private fund advisers may seek to qualify instead for a partial exemption the SEC has proposed for advisers to "qualifying private funds." Section 203(m) of the Act directed the SEC to give a limited exemption to any investment adviser that advises solely private funds and has less than $150 million in assets under management[12] in the United States.

The Rule: Rule 203(m)-1 is the rule that implements this Dodd-Frank mandate (the "PFA Rule"). However, unlike the foreign private adviser exemption, which is a complete exemption, the private fund adviser exemption is essentially a partial exemption, as advisers relying upon this exemption will be subject to significant reporting requirements and SEC examinations despite being exempt from registration.[13]

The elements of this exemption apply to non-U.S. advisers in specific ways. First, non-U.S. advisers need to consider which clients matter for purposes of the PFA Rule. For non-U.S. advisers, the condition that all of the adviser's clients be "qualifying private funds" applies only to clients that are U.S. persons, again, with reference to the definition of "United States person" in Regulation S. The size, number and nature of a non-U.S. adviser's clients, assets, or advisory, or other business activities outside the United States, will not affect the availability of this exemption. In addition, a client will not be considered a U.S. person if the client was not a U.S. person at the time of becoming a client.[14] One caveat is that single-investor funds may not be qualifying private funds for purposes of the private fund adviser exemption. When single-investor funds-often called "funds of one"-are tantamount to separately managed accounts, § 208 of the Act may dictate that the adviser consider the underlying investor as the client.[15] In addition, the Adopting Release expands the definition of "qualifying private fund," allowing an adviser to treat as a qualifying private fund a fund that that is excluded from the definition of "investment company" by any part of the § 3 of the Company Act, in addition to the exclusions provided by § 3(c)(1) or §3(c)(7) of the Company Act. The PFA Rule also closes a foreseeable loophole by requiring relying advisers to treat a discretionary or other fiduciary account as a U.S. person if the account is held for the benefit of a U.S. person by a non-U.S. fiduciary that is a related person of the adviser. Finally, sub-advisers to private funds can rely on the PFA Rule so long as the sub-adviser's services relate solely to private funds, even if the party with whom the sub-adviser has contractual privity is the fund's primary adviser.

Second, a non-U.S. adviser must consider which assets to count. The PFA Rule measures "assets under management in the United States." Under the PFA Rule, advisers with a principal place of business in the United States must count all private fund assets toward the $150 million threshold. For non-U.S. advisers (i.e., advisers with their principal place of business outside the United States), the SEC interpreted "in the United States" to include only assets managed at a place of business in the United States. Explaining this interpretation, the SEC stated "non-US activities of non-US advisers are less likely to implicate US regulatory interests and [the interpretation] is in keeping with general principles of international comity. The rule also is designed to encourage the participation of non-US advisers in the US market by applying the US securities laws in a manner that does not impose US regulatory and operational requirements on a non-US adviser's non-US advisory business."[16]

"Assets under management" is defined in the Act as the securities portfolios for which an adviser provides "continuous and regular supervisory or management services," generally defined as security selection and the making of investment recommendations based upon the needs of the client.[17] As in the FPA Rule, a "place of business" is determined by reference to the definition in Rule 222-1 under the Act, as any office where the adviser "regularly provides advisory services, solicits, meets with, or otherwise communicates with clients," and any other location that is held out to the public as a location where the adviser conducts such activities. The benefit of this distinction is that advisers of large private funds can conduct research from a place of business in the United States without losing the benefit of the private fund adviser exemption. Although the Adopting Release states that research activities meet the definition of "advisory services" as used in the "place of business" definition because "research is intrinsic to the provision of investment advisory services,"[18] it goes on to say that research or due diligence do not constitute "continuous and regular supervisory or management services" under the definition of "assets under management."[19] Accordingly, a non-U.S. adviser, that has no U.S. clients that are not private funds (including advisers that have no U.S. clients at all) that does not conduct portfolio management activity-i.e., the actual investment selection-from a U.S. place of business, will always have less than $150 million in "assets under management in the United States" for purposes of this exemption.

Finally, non-U.S. advisers will need to consider which parts of their business to account for in establishing compliance with the exemption. The Adopting Release specifically states that two or more affiliated advisers that are separately organized but operationally integrated would be viewed as a single adviser. Separate entities that operate independently generally may apply the Act and its rules independently. In some facts and circumstances, however, the SEC may integrate legally separate entities for regulatory purposes, and the Adopting Release affirms the relevance of factors previously articulated by the SEC on this point,[20] in the Unibanco letters, a widely consulted series of no-action letters in which the staff gave comfort about the circumstances under which non-U.S. advisers affiliated with U.S. advisers could remain unregistered. The Adopting Release does not, however, entirely reaffirm the applicability of the Unibanco.[21] While confirming that "[n]othing in the rules we are adopting in this Release is intended to withdraw any prior statement of the Commission or the views of the staff as expressed in the Unibanco letters," the SEC noted that the Unibanco letters were issued in the context of the private adviser exemption, which Dodd Frank repeals. The SEC anticipates the industry will seek, and the SEC staff will provide, new guidance regarding the application of Unibanco in the context of the new foreign private adviser exemption and the private fund adviser exemption.

What this means to non-U.S. private fund advisers

Non-U.S. advisers who meet the narrow terms of the foreign private adviser exemption will enjoy total exemption from the SEC's registration, reporting and examination requirements. Non-U.S. advisers relying on the private fund adviser exemption are subject to the recordkeeping and reporting requirements applicable to exempt reporting advisers, and remain subject to the Act's antifraud provisions. The reporting requirements include disclosure of certain identifying information, the exemption from registration relied on, other business activities, financial industry affiliations, information about private funds advised and the funds' service providers, identities of all control persons, and the disciplinary history of the adviser and its employees. Exempt advisers will make these disclosures by completing substantial portions of Form ADV (the SEC's registration form for investment advisers), which would be publicly available through the SEC's Investment Adviser Registration Depository ("IARD").

Non-U.S. advisers who do not meet the terms of the foreign private adviser exemption or the private fund adviser exemption will need to register by March 31, 2012. Reed Smith clients registering for the first time are advised to begin such projects with approximately four months lead time.

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1. See Advisers Act Rel. No. 3222 (June 16, 2011), available here.

2. Section 203(b)(3) of the Act states that adviser registration requirements shall not apply to "any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under title I of this Act, or a company which has elected to be a business development company pursuant to §54 of title I of this Act and has not withdrawn its election."

3. "Place of business" is defined for this purpose as it is in Rule 222-1 under the Act, namely, "as any office where the adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients," and any location held out to the public as a place where the adviser conducts such activities. It is a fact and circumstances test. Non-U.S. advisers with U.S. affiliates will not be presumed to have a U.S. place of business; it remains a question of whether the non-U.S. adviser conducts the above described activities at the U.S. offices of its affiliate.

4. "Private funds" are defined to mean funds that would be investment companies but for the exemptions in § 3(c)(1) and § 3(c)(7) of the Investment Company Act of 1940 (the "Company Act"). See § 202(a)(29) of the Act as amended by Dodd-Frank.

5. Rule 203(m)-1(d)(8). See Adopting Release, fn403 and fn409 and accompanying text.

6. The SEC did not exercise its authority to raise this threshold above $25 million. Advisers must measure assets under management by reference to the calculation of "regulatory assets under management" for Item 5 of Form ADV. Rule 202(a)(30)-1(c)(1).

7. "Whether a non-US adviser with no place of business in the United States and no US clients would be subject to registration depends on whether there is sufficient use of U.S. jurisdictional means." See Adopting Release, fn415.

8. As suggested by the American Bar Association, the SEC now recognizes "spousal equivalents" defined as "cohabitants occupying a relationship generally equivalent to that of a spouse." Rule 202(a)(30)-1(a)(1).

9. Rule 202(a)(30)-1(b)(4)-(5).

10. See Adopting Release, fn458 and accompanying text.

11. Rule 202(a)(30)-1(c)(2) defines the term "investors" generally to include persons that must be counted for purposes of § 3(c)(1) of the Company Act or qualified purchasers for purposes of § 3(c)(7) of that Act. See Adopting Release, fn447. The Release also provides that an adviser may treat any investor the adviser reasonably believes is not in the United States as not being "in the United States."

12. Assets under management must be calculated as for reporting purposes in Form ADV, including proprietary assets, assets managed without compensation and uncalled capital commitments. Assets must be valued at market value or at a fair value if market values are not available, and must be calculated on a gross basis without deducting liabilities, including accrued fees and expenses or the amount of any leverage. Valuation may be in accordance with GAAP or any other standard applied consistently and in good faith. Advisers' continued eligibility is based on annual recalculation of AUM, and interim fluctuations are of no effect. See Adopting Release, fn332 and accompanying text.

13. The Commission has the authority to require an investment adviser to maintain records and provide reports, as well as the authority to examine such adviser's records, unless the adviser is

"specifically exempted" from the requirement to register pursuant to § 203(b) of the Advisers Act. See Adopting Release, fn5.

14. Rule 203(m)-1(b)(1). See Adopting Release, fn315 and fn403.

15. See Adopting Release, fn324 and fn325 and accompanying text.

16. See Adopting Release, fn392 and fn393 and accompanying text.

17. An adviser provides continuous and regular supervisory or management services if it has ongoing responsibility to select or make recommendations as to securities or other investments, based upon the needs of the client, and if such recommendations are accepted by the client, the adviser is responsible for arranging or effecting the purchase or sale of such investments. See Adopting Release, fn401 and accompanying text.

18. See Adopting Release, fn493 and accompanying text.

19. See Adopting Release, fn401.

20. Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981).

21. See Adopting Release, fn508.