

Investment Funds Alert

SEC Adopts Rules Clarifying Registration Exemption for “Foreign Private Advisers”

July 13, 2011

On June 22, 2011, the Securities and Exchange Commission (SEC) adopted rules to clarify the new exemption from registration in the Investment Advisers Act of 1940 (the “Advisers Act”) added by the Dodd-Frank Wall Street Reform Protection Act (the “Dodd-Frank Act”) for investment advisers that do not have an office in the United States and have limited contacts with clients or investors in the United States. In addition, the SEC adopted amendments to Form ADV that will change the methodology of computing of assets under management (AUM) for these purposes.

The foreign private adviser rules will be effective on July 21, 2011, with a delayed compliance date until March 30, 2012.

Foreign Private Advisers

The Dodd-Frank Act added an exemption from SEC registration in Section 203(b)(3) for “foreign private advisers.” A “foreign private adviser” is defined as an investment adviser that (i) has no place of business in the United States, (ii) has less than \$25 million in AUM related to clients or investors located in the United States or such higher amount as the SEC sets by rule, (iii) has fewer than 15 clients and investors in private funds in the United States and (iv) does not hold itself out generally to the public in the United States as an investment adviser. The newly adopted SEC rules refine each of these factors.

How will a foreign private adviser determine how many clients in the United States it has?

A potential foreign private adviser will determine its number of clients in a similar manner to the counting of clients for the current “fewer than 15 clients” exemption.¹ The only differences are that clients for which an adviser receives no compensation will be required to be counted and that private funds that have investors that are counted for the separate investor test (below) will not be required to be counted as a client. A potential foreign private adviser will generally only be required to count clients that are “U.S. persons,” as defined under Regulation S under the Securities Act.

Who will be counted as investors in the United States?

The rules look to whether a person would be counted in determining the number of beneficial owners in Section 3(c)(1) of the Investment Company Act of 1940 (the “Company Act”) or whether outstanding securities, including debt securities, are owned exclusively by qualified purchasers under Section 3(c)(7) of the Company Act (including applicable look-throughs) in order to determine who is an investor, subject to several exceptions and clarifications.

¹ The new rules, as in the counting rules for the “fewer than 15 clients” exemption, will count the following as one client: an entity receiving advice based on its investment objectives; two entities with the same owners; an individual together with his or her minor children, cohabitating spouse (or spousal equivalent) or relatives, and related trusts and accounts.



First, any beneficial owner of outstanding short-term paper is counted as an investor. Second, any investors in a feeder fund formed for the purpose of investing in a master fund advised by a potential foreign private adviser will also be counted. Third, any person holding an interest through a nominee arrangement or total return swap will be counted as an investor.² In contrast to the original terms in the proposal, an investment adviser's key employees³ are not counted toward the investor limit. According to the SEC's previous guidance for 3(c)(1) and 3(c)(7) exclusions, a potential foreign private adviser will generally be required to count only investors that are "U.S. persons," as defined under Regulation S under the Securities Act.

Will clients or investors that were not in the United States at the time of investment or of becoming a client and that subsequently move to the United States disqualify an investment adviser from relying on the exemption?

A client that moves to the United States subsequent to his or her becoming an investor or client will not be counted toward the above limit. An investor that is not in the United States at the time of each acquisition of securities satisfies the test regardless of any subsequent move to the United States.

How are the \$25 million in AUM determined?

The AUM attributable to United States clients and investors will be measured using regulatory AUM as defined below.

What is a place of business in the United States?

A "place of business" is defined as "an office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, as well as any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients."⁴ The place of business is deemed to be in the United States if it is located in the United States of America, its territories and possessions, any state of the United States or the District of Columbia.

Will an office that only conducts research or recordkeeping services be considered as a "place of business" in the United States?

Although conducting research will not be deemed to be "managing" assets for certain other exemptions from registration, research is so intrinsic to the advisory process that the SEC will deem a location in the United States providing research to be a place of business in the United States that would disqualify investment advisers from relying on the foreign private adviser exemption. Back-office or administrative services performed from the United States typically will not result in a place of business in the United States.

Changes to AUM Calculation

The rules discussed above require determinations of an investment adviser's "regulatory AUM." Regulatory AUM is a new term used to indicate the AUM of an investment adviser as determined in accordance with specified instructions to Part 1A of Form ADV (rather than for purposes of Part 2A of Form ADV). The calculation of regulatory AUM in the instructions to Part 1A of Form ADV is similar to previous versions, with a few changes for private funds and discretionary assets. Under both the current and the revised AUM definition, "AUM" is defined as the value of securities portfolios with respect to which the investment adviser provides continuous and regular supervisory or management services. The new regulatory AUM definition changes the accounts to be counted as "securities portfolios" and the value of those securities portfolios. To review the definition of regulatory AUM and a further

² The adopting release states that if an investment adviser reasonably believes that the record owner is the actual owner, the adviser would not be required to look to the swap counterparty. The SEC did not state if reasonableness presumes due inquiry.

³ The term as used is defined in Rule 3c-5 under the Company Act.

⁴ Rule 222-1 under the Advisors Act.

description of what constitutes continuous and regular supervisory or management services, see instruction 5.F. available [here](#).

How will the changes to Form ADV affect the accounts that are determined to be “securities portfolios?”

The current definition of AUM allows, but does not require, investment advisers to include securities portfolios that are (i) proprietary and family assets, (ii) assets managed without compensation and (iii) assets of clients that are not United States persons.⁵ The amended Form ADV will require investment advisers to include those securities portfolios in regulatory AUM. The amended Form ADV will also require investment advisers to include all of the assets of private funds as a securities portfolio regardless of the nature of those assets and include any uncalled capital commitments in that securities portfolio.

How will the amendments to Form ADV change the calculation of the value of the regulatory AUM?

As with the previous AUM calculation, an adviser will be required to calculate the AUM based on the current market value of the assets determined within 90 days of the filing of the relevant Form ADV. The revised Form ADV will define a private fund’s AUM to be the current market value or, in the event that market quotations are unavailable, fair value of the private fund’s assets. Any fair valuing will be in accordance with generally accepted accounting standards or another international accounting standard.

How will a sub-adviser’s regulatory AUM be calculated?

A sub-adviser’s regulatory AUM will only include that portion of the portfolio for which the sub-adviser provides continuous and regular supervisory or management services.

Will the assets be reduced for liabilities or debt?

No, the previous AUM calculation stated that securities purchased on margin should not be deducted. The new Form ADV will expand the exclusion to prohibit an adviser from subtracting any outstanding indebtedness and other accrued but unpaid liabilities that remain in a client’s account and are managed by the adviser. Investment advisers could use the total value of assets in a double-entry balance sheet.

Conclusion

For many non-U.S. investment advisers, the Advisers Act as amended by the Dodd-Frank Act reflects a more expansive interpretation of SEC jurisdiction. However, investment advisers with a principal office and place of business outside of the United States will frequently be able to rely on the new exemption for advisers that only advise private funds and have less than \$150 million in AUM in the United States (for more information on that exemption, see this [release](#)). The SEC also reaffirmed that it will continue its previous line of “Unibanco” no-action letters, which permit investment advisers outside of the United States to “ring fence” their activities so that SEC registration results in the application of the substantive requirements of the Advisers Act only with respect to activities and practices that affect clients that are United States persons.

⁵ Although a person is not an investment adviser for purposes of the Advisers Act unless it receives compensation for providing advice to others, once it meets that definition, the Advisers Act applies to the relationship between the adviser and any of its clients.

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