SPOTLIGHT ON

Registration and Compliance Requirements for Foreign Investment Advisors with U.S. Clients

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Foreign investment advisors often wonder whether they must register with the Securities and Exchange Commission ("SEC") or U.S. state securities regulators if they have or solicit United States clients.

Generally speaking, advisors are subject to U.S. federal and state registration rules if they have any U.S. clients or solicit any U.S. clients. However, U.S. rules are applied differently to foreign advisors in several respects.

Most importantly, foreign advisors' primary regulator is the SEC. Foreign advisors with U.S. clients must register with the SEC (rather than a state) regardless of the amount of assets under management ("AUM"). (U.S.-based advisors, by contrast, typically can only register with the SEC if they have more than $100 million AUM. Smaller U.S. advisors must register with the state(s) where they have offices and/or a certain number of clients.)[1]

Foreign advisors do not need to register with the SEC if they fall under one of three exemptions, for: (1) advisors solely advising venture capital funds, (2) advisors solely advising private funds in the U.S. if private fund AUM in the United States are less than $150 million, and (3) certain foreign private advisors. See generally 15 U.S.C. § 80b-3; see 17 C.F.R. § 275.203(l)-1 (the venture capital fund exemption); see 17 C.F.R. § 275.203(m)-1 (the private fund advisor exemption); see 15 U.S.C. § 80b-2(a)(30) and 17 C.F.R. § 275.202(a)(30)-1 (the foreign private advisor exemption).

We discuss these three exemptions in this Spotlight.

Please keep in mind that foreign advisors that are exempt from SEC registration may still need to register with one or more states. Specifically, unless they qualify for an exemption from registration under state law, SEC-exempt foreign advisors must register with any state in which they have 5 or more clients, although the rules differ by state.

[1]SEC-registered foreign advisors must comply with the Investment Advisers Act of 1940 (the "Act") with respect to the firm's current and prospective U.S. clients. But most of the Act's requirements (except recordkeeping and examination provisions) <u>do not</u> apply to foreign advisors' management of their non-U.S. clients.

These state rules are discussed in our Spotlight on State Registration Requirements for “Small” Investment Advisors.

In addition, foreign advisors exempt from registration must still abide by the antifraud provisions of the Act, including the “Pay-to-Play Rule.” The Pay-to-Play Rule generally prohibits an advisor from receiving compensation for providing advisory services to certain government entities within two years after the advisor or its covered associates make a political contribution to a government official or candidate who will be in a position to influence the award of advisory business, and poses certain restrictions on the advisor and its covered associates’ solicitation and coordination of political contributions.

The foreign private advisor exemption

The SEC exempts foreign advisors with a (relatively) small amount of U.S. business from registration. Specifically, foreign advisors are exempt from SEC registration if the firm meets each of the following criteria:

- Has no place of business in the United States;
- Has fewer than 15 clients and investors in the United States in private funds advised by the investment advisor, combined;
- Manages less than $25 million AUM for those clients in the United States and investors in the United States in private funds advised by the investment advisor;
- Does not hold itself out generally to the public in the United States as an investment advisor; and
- Does not act as an investment advisor to any registered investment companies or companies that elected to be business development companies.

See 15 U.S.C. §§ 80b–2(a)(30), 80b-3(b)(3).

We explain each of these requirements in more detail below.

What constitutes a “place of business” in the United States?

To qualify for this exemption, foreign advisors cannot have any place of business in the United States. Federal rules define a “place of business” of an investment advisor as:

- Any office at which the advisor regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients; and
- Any other location held out to the general public as a location where the advisor conducts the above activities. See 17 C.F.R. § 275.222-1.

The foreign private advisor exemption (cont.)

This includes: (a) any office from which the foreign advisor regularly communicates with its U.S or non-U.S. clients, and (b) any office or another location where the advisor regularly conducts research. But an office where the advisor only performs administrative and back-office activities generally is not considered a "place of business."

Who counts as a "client"?

A "client" is defined as any person for whom a firm provides advisory services, regardless of whether the advisor is paid/compensated for these services.

Counting the number of clients an advisor has is not as simple as counting the number of customers an advisor has because some groups of customers count as a single "client."

Under federal law, advisors may treat the following people and personal vehicles as a single "client":

- A natural person, and:
    - Any minor child of the natural person, whether or not he or she shares the same principal residence as the natural person;
    - Any relative, spouse (or spousal equivalent), or relative of the spouse who has the same principal residence; and
    - All accounts and trusts of which the natural person and/or the relatives discussed above are the only primary beneficiaries.

See 17 C.F.R. § 275.202(a)(30)-1.

The SEC has adopted similar rules for counting the number of organizational "clients" a foreign private advisor has:

- An advisor may treat as a single "client" two or more corporations, partnerships or other legal entities:
    - that have identical shareholders, partners, members, or beneficiaries; or
    - to which the advisor is providing investment advice based on the organization's investment objectives. (An owner of any of these legal entities may also be a separate client, but only if he gets investment advisory services separate from the legal entity.)
    - An advisor must count as a client any limited partnership or limited liability company for which the advisor acts as a general partner, managing member, or investment advisor.

The foreign private advisor exemption (cont.)

Who counts as a private fund "investor"?

For purposes of the foreign private advisor exemption, an "investor" in a private fund is generally any beneficial owner of the fund, i.e., anyone who buys into a private fund. (Technically, an "investor" is defined in 17 C.F.R. § 275.202(a)(30)(1) as anyone who is a beneficial owner under section 3(c)(1) of the Investment Company Act, a qualified purchaser under section 3(c)(7) of that Act (or a beneficial owner of any short-term paper issued by the fund).) Holders of both equity and debt securities count as investors.

Foreign advisors cannot just count a private fund (including hedge fund) as one investor. Rather, U.S. rules require foreign advisors to "look through" to the underlying investors in the fund and count each one. Specifically, advisors must count the following as "investors":

- All direct investors in the fund;
- In the case of master-feeder structures or other layered funds, the investors in any feeder or layer;
- The owners of total return swaps on the private fund; and
- The holders of the private fund's debt, including short-term paper (unless the extension of credit by a fund's broker-dealer or custodian bank does not result in the issuance of a security by the fund to its creditor).

There are a few rules designed to prevent foreign advisors from having to double-count clients:

- A private fund itself does not count as a client if the advisor counted any investors in the private fund as investors in the U.S. in the private fund;
- You only have to count people once. A person who is both an individual client of the advisor and an investor in a private fund the advisor manages is only counted as one "client." Likewise, a person invested in two or more funds advised by the same advisor is only counted once.

This foreign private advisor exemption generally requires foreign advisors to count U.S. investors in the private funds they advise toward the 15-client/investor limit, regardless of whether the fund is a U.S. or non-U.S. domiciled fund.

What does "in the United States" mean?

The private fund advisor exemption is available only to foreign advisors without a place of business in the United States who do not hold themselves out to the public in the United States as investment advisors and have a limited number of U.S. clients/investors and AUM from U.S. clients and investors. It is therefore essential to understand the term "in the United States" to know when this exemption applies.

The foreign private advisor exemption (cont.)

The term "in the United States" focuses on the person's residency, not citizenship. (It is based on the definition of a "U.S. person" and "United States" in Regulation S.) For instance, the following are considered "U.S. persons" and thus U.S. clients and investors for purposes of the foreign private advisor exemption:

- Any natural person resident in the United States;
- Any partnership or corporation organized or incorporated under the laws of the United States;
- Any non-discretionary or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a U.S. person; and
- Any discretionary or similar account (other than an estate or trust) held by a dealer or other fiduciary organized, incorporated, or (if an individual) resident in the United States.

Timing is important when evaluating whether a person or investor is "in the United States." <u>The exemption looks only at whether the client or private fund investor was in the United States at the time he became a client or, for private fund investors, each time he made an investment in a fund</u>. This means that foreign private advisors can continue relying on this exemption even if one of their non-U.S. clients later becomes a U.S. person. This is designed to reduce the burden on advisors. Advisors do not need to constantly monitor the location of their clients and investors or choose between registering with the SEC or terminating their relationship with a client or investor because the client moved to the United States.

What assets does an advisor need to count under this exemption?

Unlike with U.S. advisors, the SEC only looks at the AUM managed for U.S. clients and private fund investors in determining whether a foreign advisor manages so many assets that it must register with the SEC. Non-U.S. assets are irrelevant.

What does it mean for a firm to hold itself out as an investment advisor?

Generally, the SEC will consider a firm or person to be holding himself out as an advisor if he advertises as an investment advisor or financial planner, uses letterhead indicating an investment advisory business, maintains a telephone listing, or otherwise publicizes that it accepts new advisory clients, or hires a person to solicit clients on its behalf.

Simply participating in a non-public offering in the United States of securities issued by a private fund pursuant to an exemption from registration under the Securities Act of 1933 does not constitute holding oneself out as an investment advisor.

The foreign private advisor exemption (cont.)

An advisor providing information about itself through the Internet (e.g., website) is not generally considered to be "holding itself out" as an advisor in the U.S. as long as the website makes clear that it is not targeting U.S. persons. The SEC has made clear that it will not consider a non-U.S. advisor, including a foreign private advisor, to be holding itself out as an advisor if:

- The advisor's website contains a prominent disclaimer clearly stating that its website is not directed to U.S. persons; and
- The advisor implements procedures reasonably designed to ensure that it does not send materials about its advisory services to U.S. persons, for instance by asking potential clients for residency information before providing additional materials.

Foreign advisors relying on this exemption should periodically make sure they meet each of the elements of this exemption, especially given the limited number of clients/investors and AUM allowed and the complex rules governing the counting of private fund investors. Foreign advisors with $25 million or more in assets of U.S. clients or U.S. investors in their private funds, 15 or more U.S. clients or U.S. investors in their private funds, or even just a place of business in the United States will need to register with the SEC unless they qualify for another exemption.

The private fund exemption

Foreign hedge fund managers or advisors may also be exempt from SEC registration under the private fund exemption.

A private fund advisor is exempt from registration if its only U.S. clients are private funds and it manages less than $150 million of private fund assets in the United States. Under this exemption, a private fund advisor may manage an unlimited number of private funds so long as it has less than $150 million AUM. But if it advises just one other type of U.S. client (such as a separately managed account with a non-private fund client), it must register with the SEC unless another exemption is available.

Non-U.S. advisors, i.e., advisors with their principal place of business outside the United States, may rely on the private fund exemption from registration if:

- Their only U.S. clients are "qualifying" private funds (e.g., hedge funds, private equity funds); and
- All assets managed by the advisors at a place of business in the United States belong to a private fund and amount to less than $150 million.

See 17 C.F.R. § 275.203(m)-1(b).

The private fund exemption (cont.)

Foreign advisors may use this exemption from SEC registration regardless of the type or number of non-U.S. clients or the amount of assets managed outside the United States. The SEC only looks at U.S. clients and private funds managed from a place of business in the United States for purposes of this exemption.

This effectively means that non-U.S. advisors may do the following without this affecting their U.S. registration requirements:

- Have clients outside the United States that are not private funds;
- Advise multiple separately managed accounts of non-U.S. persons from a place of business outside the United States;
- Manage an unlimited amount of private fund assets if their principal office and place of business is outside the United States and they do not manage any assets of U.S. persons other than private funds; and
- Manage U.S. private funds with more than $150 million AUM from non-U.S. locations.

What is a “qualifying private fund”?

A “qualifying private fund” is any hedge fund, private equity funds and other type of pooled investment vehicle that is not registered under the Investment Company Act of 1940 (i.e., qualifies for an exclusion from the definition of “investment company”) and has not elected to be treated as a business development company.

What is a “place of business” and a “principal office and place of business”?

To qualify for this exemption from SEC registration, foreign advisors must have their principal place of business outside the United States. They can also only manage up to $150 million private fund AUM from a place of business in the United States.

An advisor’s “principal place of business” is the location where the advisor controls, or has ultimate responsibility for, the management of private fund assets (even though day-to-day management of certain assets may also take place at another location, which may be in the United States). This definition is intended to simplify the analysis for firms with multiple offices, such as when assets are managed by teams located in multiple jurisdictions or portfolio managers in one jurisdiction rely heavily on research or other services performed by employees located in a different jurisdiction.

The private fund exemption (cont.)

The SEC defines a "place of business" for purposes of this exemption the same way it does for the foreign private advisor exemption (which we described above). Whether a non-U.S. advisor has a place of business in the United States depends on the facts and circumstances. But the analysis will frequently turn on whether the advisor manages assets or holds assets at a U.S. place of business, not just whether the advisor has a U.S. office. This is because simply providing research or conducting due diligence is not enough to make an office an advisor's "place of business" because these activities are not considered "continuous and regular supervisory or management services" in the U.S. if a person outside the United States makes and implements independent investment decisions.

Calculating AUM

To determine whether they come under the $150 million AUM threshold of this exemption, advisors must include in their AUM calculation the following types of assets:

- Proprietary assets;
- Assets managed without compensation; and
- Uncalled capital commitments.

Also, advisors must determine the amount of private fund assets based on their market value (or fair value if market value is unavailable), and on a gross basis (without deducting liabilities, such as accrued fees and expenses or the amount of borrowing).

Advisors relying on this exemption must determine annually whether they have $150 million or more in private fund AUM, and they must report their AUM in annual updating amendments to their Form ADV.

Advisors with $150 million or more in private fund AUM in the United States must register with the SEC (unless they qualify for another exemption). Advisors have 90 days after filing their annual Form ADV reflecting the $150 million AUM to register with the SEC, if they previously complied with the exempt reporting requirements and may continue to act as private fund advisors during this transition period. This effectively allows advisors who become ineligible for the exemption because they manage more than $150 million in U.S. assets 180 days after the end of their fiscal year to register with the SEC. But advisors must file the registration application at least 45
days before this deadline to ensure that the registration becomes effective before the advisor's exemption expires.

The venture capital fund exemption

U.S. and non-U.S. investment advisors who only advise one or more venture capital funds are also exempt from registration with the SEC, regardless of where those funds are located.

Non-U.S. advisors may rely on the venture capital exemption if all of their clients (U.S. and non-U.S.) are venture capital funds. Unlike with the private fund exemption, non-U.S. advisors cannot disregard their non-U.S. activities.

Advisors that want to provide advice to clients other than venture capital funds – which would make the advisor ineligible for this exemption – must register before providing advice to those other clients.

The bottom line

Of the three exemptions, the foreign private advisor exemption is considered the narrowest because it places severe limitations on the number of clients and investors in the United States and the amount of AUM of these clients and investors, requires advisors to look-through private funds to count their investors and invested capital, and expects advisors to constantly monitor their AUM. The foreign private advisor exemption is most useful for non-U.S. advisors who do not conduct large volumes of advisory business in the U.S. or source a lot of capital from U.S. clients or investors. By contrast, non-U.S. advisors may use the private fund exemption regardless of the number or type of non-U.S. clients or the amounts of assets managed from a place of business outside the United States and may manage up to $150 million in private fund AUM from a U.S. location.

Nonetheless, the foreign private advisor exemption has the advantage of being the only one of the three that does not involve any reporting obligations. Although exempt from registration, advisors relying on the private fund or the venture capital fund exemptions (referred to as "exempt reporting advisors") must file a Form ADV within 60 days of relying on one of the two exemptions, must annually update their Form ADV, are subject to examination, and must adhere to the antifraud provisions of the Act.

Unlike registered advisors, exempt reporting advisors only need to fill out a subset of items in Part 1A of Form ADV and none of the narrative disclosure in Part 2. Like registered advisors, exempt reporting advisors must also report a variety of detailed information about the private funds they advise. (This includes information about master and feeder funds, the type of fund based on its investment strategy, gross asset value, auditor information, whether financial statements are prepared and audited in accordance with US GAAP, the fund's prime broker, custodian, and administrator, etc.). Non-U.S. advisors only need to provide this information about the U.S. funds they advise, not non-U.S. funds not offered or sold in the United States or to U.S. persons.

Please keep in mind that these exemptions are specific and technical and advisors must meet the specific requirements of one of these exemptions to avoid SEC registration. Advisors cannot mix and match elements of the three exemptions to avoid registration as an investment advisor.

Finally, as noted above, foreign advisors that qualify for one of these exemptions from SEC registration must still confirm whether they need to register with the states in which they have clients or offices and whether they have any reporting obligations under the Securities Exchange Act of 1934 (e.g., Section 13 filings).