US Securities and Exchange Commission Issues Proposed Rule

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On November 19, 2010, the US Securities and Exchange Commission (the " SEC") issued Release IA-3111 (the "Proposing Release") setting forth proposed rule 202(a)(30)-1 (the "Proposed Rule") that will, when final, implement the foreign private adviser exemption. In this Briefing Note we will summarize the most significant aspects of the Proposed Rule. The Proposed Rule, which is not yet final, would have the effect of significantly increasing the number of non-US investment advisers, including fund managers, that are subject to registration with and regulation by the SEC. Those wishing to comment on the Proposed Rule should submit comments to the SEC by the first week of January 2011.

Background

On July 21, 2010, President Obama signed into law the Dodd-Frank Act, which amends the US Investment Advisers Act of 1940 (the "Advisers Act") by, among other things, repealing the so called "Private Adviser Exemption" that currently exempts advisers with fewer than 15 clients from SEC registration and regulation. Repeal of the current Private Adviser Exemption becomes effective on July 21, 2011. In place of the Private Adviser Exemption, the Dodd-Frank Act creates several new exemptions, one of which is for "foreign private advisers."

Section 403 of the Dodd-Frank Act defines "foreign private adviser" as an investment adviser that (i) has no place of business in the US, (ii) has fewer than 15 clients in the US and investors in the US in private funds advised by the adviser, and (iii) has less than $25 million in aggregate assets under management from such clients and investors.

The Proposed Rule

Although the foreign private adviser exemption is mandated by the Dodd-Frank Act, several terms used in the statutory definition of foreign private adviser are not currently defined in any of the Dodd-Frank Act, the Advisers Act or the SEC rules issued under the Advisers Act. As such, in order to implement the foreign private adviser exemption, the SEC issued the Proposed Rule to define the terms used in the statutory definition of foreign private adviser. In the accompanying Proposing Release, the SEC provides additional guidance on the manner in which it will interpret the exemption.

Place of Business

The first requirement set forth in the Dodd-Frank Act for an investment adviser, including a fund manager, seeking to rely on the foreign private adviser exemption is that such investment adviser or fund manager not have a place of business in the US. For purposes of this requirement, the US is defined to include any state in the US, the District of Columbia or any territory or possession of the US.

The Proposed Rule defines "place of business" to mean any office where the investment adviser regularly provides 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 any such activities. We note that this is a much broader test than the "principal office and place of business" test previously used to determine whether an investment adviser was required to count non-US clients against the 15 client limit under the Private Adviser Exemption. The principal place of business test previously focused on the location where management decisions were made.

It would appear that, under the definition contained in the Proposed Rule, any investment adviser or fund manager that has an employee stationed in the US that meets with clients or investors at a fixed location will fail to qualify as a foreign private adviser.

Clients and Investors in Private Funds

The second requirement set forth in the Dodd-Frank Act for an investment adviser, including a fund manager, seeking to rely on the foreign private adviser exemption is that such investment adviser or fund manager have fewer than 15 clients in the US and investors in the US in private funds advised by the adviser. In order for an investment adviser or fund manager to determine whether they satisfy this requirement, the Proposed Rule sets forth the method to be used for counting clients and private fund investors.

Clients

With the notable exception of private funds, the Proposed Rule carries forward the rules used to count clients under the current Private Adviser Exemption. As such, an investment adviser may treat as a single client a natural person and: (i) that person's minor children (whether or not they share the natural person's principal residence); (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal

residence; (iii) all accounts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries; and (iv) all trusts of which the natural person and/or the person's minor child or relative, spouse, or relative of the spouse who has the same principal residence are the only primary beneficiaries. The Proposed Rule would also allow an investment adviser to treat as a single client: (i) a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization to which the adviser provides investment advice based on the organization's investment objectives, and (ii) two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries. However, in the event that any such legal organization is a collective investment vehicle excluded from the definition of investment company by Sections 3©(1) or 3©(7) of the Investment Company Act of 1940 (the "Company Act"), reference must be made to the number of investors in such private fund as discussed below.

It should be noted that the SEC has specifically declined to include a provision in the Proposed Rule that would allow investment advisers to exclude as clients any person for whom the investment adviser provides investment advisory services without compensation. Rather, such non-paying advisees are specifically required to be counted as clients. If a client relationship involving multiple persons does not fall within the rule, the question of whether the relationship may appropriately be treated as a single "client" must be determined on the basis of the facts and circumstances involved.

Private Fund Investors

As noted above, special rules apply to legal organizations that constitute private funds. For collective investment vehicles excluded from the definition of investment company by Sections 3©(1) or 3©(7) of the Company Act, the investment adviser or fund manager must count each investor in the private fund against the 15 client and investor limitation.

The term investor is not currently defined under the Advisers Act. In order to insure proper coordination of the various US securities laws relating to private funds, the Proposed Rule defines an investor as any person who would be (i) included in determining the number of beneficial owners of the outstanding securities of a Section 3©(1) private fund, or (ii) required to be a qualified purchaser in order for a private fund to qualify for the Section 3©(7) Company Act exemption. These rules are complicated, but the SEC specifically states in the Proposing Release that advisers are required to "look through" nominee and similar arrangements to the underlying holders of private fund interests to determine whether they have fewer than 15 clients and private fund investors in the US.

The SEC acknowledges that determining the number of private fund investors will require individual determinations based on the facts and circumstances of each case. However, the SEC does provide the following specific examples.

- An adviser to a master fund in a master-feeder arrangement would have to treat as investors the holders of the securities of any feeder fund formed or operated for the purpose of investing in the master fund rather than the feeder funds, which act as conduits.

- An adviser would be required to "look through" any entity created for the purpose of making an investment and count each of its beneficial owners as investors.

- An adviser would need to count as an investor any holder of an instrument, such as a total return swap, that effectively transfers the risk of investing in the private fund away from the record owner of the private fund's securities.

- An adviser would need to count as an investor holders of both equity and debt securities.

- An adviser would need to count as an investor knowledgeable employees and holders of short term paper, even though such treatment would not be required under Sections 3©(1) or 3©(7) of the Company Act.

The requirement to count each investor in a private fund against the 15 client and investor limitation is a significant departure from current practice and is expected to significantly increase the number of non-US fund managers that are subject to registration with and regulation by the SEC.

Finally, in order for an investment adviser or fund manager to determine if it satisfies the second prong of the statutory definition of foreign private adviser, it must determine whether its clients and private fund investors are "in the United States." For this purpose, the Proposed Rule generally requires the status of a client or private fund investor to be determined using the definition of "US Person" in Regulation S.

Regulation S defines a US Person as:

- Any natural person resident in the US;
- Any partnership or corporation organized or incorporated under the laws of the US;
- Any estate of which any executor or administrator is a US person;
- Any trust of which any trustee is a US person;
- Any agency or branch of a foreign entity located in the US;
- Any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a US person;
- Any discretionary account 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 US; and
- Any partnership or corporation if:
- Organized or incorporated under the laws of any foreign jurisdiction; and
- Formed by a US person principally for the purpose of investing in securities.

In addition, the Proposed Rule treats any discretionary account owned by a US Person and managed by a non-US affiliate of the adviser as a US Person.

In order to avoid requiring an investment adviser or fund manager to monitor the ongoing location of clients and investors, the Proposed Rule allows the determination to be made once, when the individual or entity becomes a client or acquires the interest in the private fund.

It should be noted that the definition of US Person under Regulation S is broader than tests currently used to determine the status of "US clients" under the Private Adviser exemption. For example, under current tests, a corporation with its principal place of business outside the US is treated as a non-US client, even if it is formed under US law. This is no longer the case. In addition, it can be anticipated that the SEC will use the facts and circumstances tests it has cited in order to individually address situations that, while in technical compliance with the applicable requirement, the SEC feels were designed for the purpose of avoiding regulation.

Additionally, due to the requirement to count investors in private funds against the 15 client and investor limitation, non-US fund managers that accept US investors into offshore funds will no longer be able to assume that they have no US investors.

Assets under management from US clients and investors

The final requirement set forth in the Dodd-Frank Act for an investment adviser, including a fund manager, seeking to rely on the foreign private adviser exemption is that such investment adviser or fund manager have less than $25 million in assets under management from US clients and investors, without regard to the number of such clients or investors. The language of the Proposing Release is not entirely clear on this point. However, it seems safe to assume that investment advisers and fund managers would need to attribute funds held in private funds and other collective investment vehicles to each client and private fund investor in the US.

We also note that the SEC is proposing changes to the manner in which the amount of assets under management is calculated. For example, the SEC proposes that assets under management be calculated using the fair value of the assets as opposed to cost basis. Although beyond the scope of this Briefing Note, all non-US advisers that are potentially subject to regulation with the SEC should be certain to calculate the amount of assets under management in accordance with SEC requirements when determining if they qualify for the foreign private adviser exemption.

Other potential exemptions

Non-US fund managers that do not satisfy the requirements to be treated as foreign private advisers may be able to avoid the registration requirements, but not all of the reposting obligations, of the Advisers Act under exemptions designed for mid-sized investment advisers to private funds and advisers to venture capital funds. These exemptions are the subject of a separate Briefing Note.

Conclusion

As expected, the Proposed Rule implementing the foreign private adviser exemption will significantly increase the number of non-US investment advisers and fund managers subject to SEC regulation. We urge all investment advisers, including private banks and trust companies that deal with US clients, and all private fund managers that accept investments from US investors, to consult with counsel regarding the potential effects of the Dodd-Frank Act.

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