Are You a Foreign Private Adviser?

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On June 22, 2011, the US Securities and Exchange Commission (the " SEC") issued Release IA-3222 (the "Final Release") adopting rule 202(a)(30)-1 (the "Final Rule") that implements the foreign private adviser exemption. In this Briefing Note we will summarize the most significant aspects of the Final Rule and highlight where it differs significantly from the SEC's original proposal (the "Proposed Rule").

The Dodd-Frank Act amends the US Investment Advisers Act of 1940 (the "Advisers Act") by, among other things, repealing the so-called "Private Adviser Exemption" that exempts advisers with fewer than 15 clients from SEC registration and regulation. In place of the Private Adviser Exemption, the Dodd-Frank Act creates several new exemptions, one of which applies to "foreign private advisers."

Transition Period

Repeal of the current Private Adviser Exemption becomes effective on July 21, 2011. However, if an adviser will not qualify for any exemption from registration after the repeal of the Private Adviser Exemption, the adviser will not be required to register with the SEC until March 30, 2012, although the SEC recommends completing the requisite application no later than February 14, 2012.

The Foreign Private Adviser Exemption

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 US clients and/or US investors in private funds advised by the adviser, (iii) has less than $25 million in aggregate assets under management from such US clients and investors; and (iv) neither (X) holds itself out generally to the public in the US as an investment adviser, nor (Y) acts as investment adviser to any investment company registered under the Company Act (as defined below) or any company that has elected to be a business development company pursuant to the Company Act. Set forth below we provide detail on each of these requirements.

Place of Business

To qualify as a foreign private adviser, an investment adviser or fund manager may not have a place of business in the US. The Final 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. A non US adviser will not be presumed to have a place of business in the US solely because the adviser has a US affiliate. However, if the non-US adviser's personnel regularly conduct advisory activities at the affiliate's US place of business, the non-US adviser will be deemed to have a place of business in the US.

In the Final Release, the SEC acknowledges that each adviser must determine whether it has a place of business in the United States based on its own relevant facts and circumstances. However, the SEC does provide some specific examples:

- A place of business includes any office from which an adviser regularly communicates with clients, whether they are US or non-US clients.
- A place of business includes any office or other location where an adviser regularly conducts research, including research used to produce non-public information relevant to investment decisions and recommendations. While the issue was not addressed in Proposed Rule, the Final Release specifically states that the SEC considers research intrinsic to the provision of investment advisory services.
- A place of business does not include an office where an adviser solely performs administrative and back-office activities not intrinsic to the provision of investment advisory services which do not involve communication with clients.

Clients and Investors in Private Funds

To qualify as a foreign private adviser, an investment adviser or fund manager must have fewer than 15 clients in the US and/or investors in the US in private funds advised by the adviser. The Final Rule sets forth the method to be used for counting clients and private fund investors in order to satisfy this requirement.

Clients

With the notable exception of private funds, the Final Rule generally applies 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, spousal equivalent or relative of the spouse or of the spousal equivalent 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, spousal equivalent or relative of the spouse or of the spousal equivalent 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, spousal equivalent or relative of the spouse or of the spousal equivalent who has the same principal residence are the only primary beneficiaries. The Final Rule also allows 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(c)(1) or 3(c)(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.

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(c)(1) or 3(c)(7) of the Company Act, the fund adviser/manager must count each investor in the private fund against the 15 client and investor limitation.

The Final Release clarifies that in calculating the number of investors, advisers are required to "look through" nominee and similar arrangements and count certain of the underlying holders of private fund interests. 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 must 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 must "look through" any nominee entity or similar arrangement.
- An adviser must "look through" any entity created for the purpose of making an investment and count each of its beneficial owners as investors.
- An adviser must 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 must count as an investor holders of both equity and debt securities.

Since calculating the number of private fund investors requires individual determinations based on facts and circumstances, the Final Release notes that an adviser may treat as an investor a person the adviser reasonably believes is the actual investor and that, if the adviser reasonably believes that the investor is not "in the United States," the adviser may treat such investor as a non-US investor.

The Final Rule also contains several provisions that prevent investors from being double-counted. As such, an adviser need not: (i) count a private fund as a separate client if the adviser counted any of the investors in that private fund as a client for the purpose of determining the availability of the foreign private adviser exemption; (ii) count an individual as a client due to such individual's investment in a private fund if such individual has already been counted separately as a client of the adviser; and (iii) double-count an individual who is an investor in two or more private funds advised by the adviser.

The requirement to count each investor in a private fund against the 15 client and investor limitation is a significant departure from current practice.

In the United States

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 Final 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 unless it is organized or incorporated, and owned, by accredited investors who are not natural persons, estates or trusts.

In addition, the Final 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 to monitor the ongoing location of clients, the Final Rule allows the determination to be made once, at the time the individual or entity becomes a client. While the Proposed Rule also allowed a fund manager to make a single determination regarding the location of an investor at the time the investor first acquires an interest in the private fund, the Final Rule requires that the fund manager make the determination **each time** an investor acquires an additional interest in the private fund.

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 that is attributable to US clients and investors, without regard to the number of such clients or investors. Please be advised that this method of determining assets under management differs from the method used to determine assets under management for other exemptions from registration.

We also note that the SEC has adopted changes to the standard used to value assets under management. The SEC now requires that assets under management be calculated using the fair value of the assets as opposed to their 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 the reporting obligations, of the Advisers Act under exemptions available 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 Final Rule implementing the foreign private adviser exemption significantly increases 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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