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Fundamentals of Investment Adviser Regulation 2016

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Registration under the Investment Advisers Act of 1940: Who is an Investment Adviser? (May 9, 2016)

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I. INTRODUCTION

Investment advisers are subject to federal regulation under the Investment Advisers Act of 1940 (the "Advisers Act") and the rules and regulations thereunder. A significant number of investment advisers are not subject to regulation by the Securities and Exchange Commission ("SEC"), leaving them subject to state "blue sky" regulation. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), among other things, significantly changed the exemptions from registration under the Advisers Act and division of the regulation between the SEC and the states.

As discussed further below, the Advisers Act generally requires all investment advisers to register with the SEC or the states unless they are excluded from the definition of "investment adviser" (see Section II) or exempt from registration (see Section III). Even if an investment adviser is not required to register under the Advisers Act (*e.g.*, because it qualifies under an exemption), it may still be required to register under state law and be subject to certain provisions of the Advisers Act.

This outline discusses: (1) who is an investment adviser, (2) who must register as an investment adviser, (3) the applicability of state registration and regulation, (4) the registration of associated persons and affiliates and (5) the applicability to foreign advisers.

II. WHO IS AN "INVESTMENT ADVISER"?

The Advisers Act prohibits an investment adviser, including a non-U.S. investment adviser, from making use of the mails or any means or instrumentality of interstate commerce in connection with its business as an investment adviser, unless it is registered with the SEC or exempt from registration.[1] The SEC and the U.S. courts have interpreted U.S. jurisdictional means broadly to include telephone calls, facsimile messages and letters into or out of the U.S.

"Investment adviser" means any person who, *for compensation*, *engages in the business* of advising *others*, either directly or through publications or writings, as to the value of *securities* or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.[2]

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1. Advisers Act, Section 203(a).
2. Advisers Act, Section 202(a)(11).

A. Engaged in the Business

The key factor in determining whether a person is an investment adviser is the extent to which the person's advisory activities constitute being "engaged in the business" of an investment adviser. The giving of investment advice need not constitute the principal business activity or any particular portion of the business activities of a person for that person to be an investment adviser. The SEC staff has stated that the giving of advice need only be done on such a basis that it "constitutes a business activity." The frequency of the activity is a factor that, although not determinative, should be considered.

The SEC considers a person to be "engaged in the business" of providing investment advice if the person:

- holds himself or herself out as an investment adviser or as one who provides investment advice;
- receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the investment advice; or
- on anything other than rare, isolated and non-periodic instances, provides *specific investment advice*.

"Specific investment advice" is deemed to include a recommendation, analysis or report about specific securities or specific categories of securities. It also includes a recommendation that a client allocate certain percentages of his or her assets to life insurance, bonds, and mutual funds or particular types of mutual funds such as growth stock funds or money-market funds. Specific investment advice would not, however, include advice limited to a general recommendation to allocate assets in securities, life insurance, and tangible assets.[3]

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3. Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, SEC Release No. IA-1092 (Oct. 8, 1987).

B. Advising Others

An investment adviser must also be in the business of providing investment advice for compensation to “others.” The SEC staff has provided no-action relief from registration for an investment adviser who only provides advice to (i) direct and indirect wholly owned subsidiaries of the adviser or its parent company, so long as the parent company and its subsidiaries are not Private Funds,[4] (ii) funds with respect to which the parent of the investment adviser is the only investor (and there are no other holders of securities),[5] and (iii) the adviser’s employee benefit plans subject to regulation under the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), foreign employee benefit plans, and plans that consist solely of the company’s assets.[6]

C. Compensation

The definition of investment adviser applies to persons who give investment advice for “compensation.” The compensation element is satisfied by the receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, commissions, expense reimbursement or some combination of the foregoing. It is not necessary for the person receiving the advice to pay the compensation; only that the adviser receive compensation from some source.[7] The SEC staff has stated, however, that the receipt of “intangible” benefits may not constitute compensation. (For example, in the case of an employer that provides investment advice to employees, the employer would not be deemed to receive separate or additional compensation if the provision of investment information merely provides it with intangible benefits, such as the ability to attract and retain satisfied employees.)[8]

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4. Allianz of America, Inc., SEC No-Action Letter (pub. avail. May 25, 2012); MEAG MUNICH ERGO., SEC No-Action Letter (pub. avail. February 14, 2014).
5. Zenkoren Asset Management of America Inc., SEC No-Action Letter (pub. avail. Jun. 30, 2011).
6. Lockheed Martin Investment Management Co., SEC No-Action Letter (pub. avail. June 5, 2006).
7. Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, SEC Release No. IA-1092 (Oct. 8, 1987).
8. Department of Labor, SEC No-Action Letter (pub. avail. Dec. 5, 1995).

D. Definition of Security

The definition of investment adviser also only applies to persons who give investment advice with respect to "securities." The Advisers Act defines "security" broadly to mean: any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil or other mineral rights, any put, call, straddle, option or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or privilege entered into a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase any of the foregoing.[9]

E. Application of Advisers Act to Financial Planners

The SEC staff has consistently taken the view that persons providing financial planning, pension consulting or other integrated advisory services (*e.g.*, pension, sports, and entertainment consultants) are investment advisers if they (i) provide advice or issue reports or analyses regarding securities, (ii) are in the business of providing such services, and (iii) provide such services for compensation.[10]

The SEC staff believes that the first prong of this test is generally satisfied when a person provides advice, or issues or promulgates reports or analyses, that concern securities, even if the advice or reports do not relate to specific securities. In fact, such advice or reports would satisfy the test even if they only included the relative advantages and disadvantages of investing in securities in general as compared to other investments. Furthermore, advice to a client as to the selection or retention of an investment manager or managers could also be deemed to be advice regarding securities, particularly where the

9. Advisers Act, Section 202(a)(18).
10. Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services, SEC Release No. IA-1092 (Oct. 8, 1987).

advice includes a recommendation or an evaluation of the investment manager's performance.

The "in the business" and "compensation" elements of the test are the same as laid out in Sections II.A and II.C above.

The Dodd-Frank Act mandated that the General Accounting Office (the "GAO") study the oversight of financial planners. The GAO concluded that existing statutes and regulations appear to cover the great majority of financial planning services; that individual financial planners nearly always fall under one or more regulatory regimes, depending on their activities; and that an additional layer of regulation specific to financial planners is not warranted at this time. The GAO did recommend that "more robust enforcement of existing laws could strengthen oversight efforts."[11]

F. Persons Excluded from Definition of Investment Adviser

The term "investment adviser" does not include: (1) banks, (2) certain professionals (such as lawyers and accountants), (3) broker-dealers, (4) publishers, (5) certain persons who only provide advice related to certain government securities, (6) nationally recognized statistical rating organizations that do not issue recommendations, hold securities or manage assets, (7) family offices, (8) such other persons as the SEC designates, and (9) government entities.

1. Banks

A company is excluded from the definition of investment adviser if it is a bank or any bank holding company as defined in the Bank Holding Company Act of 1956, as amended, that is not an investment company and that does not act as an investment adviser to a company registered under the Investment Company Act of 1940 (the "Investment Company Act").[12] The term "bank" does not include savings and loan institutions or a foreign bank.

If a separately identifiable department or division of a bank acts as an adviser to a registered investment company, the department or division, and not the bank itself, is deemed to be the investment adviser.

11. *See* Regulatory Coverage Generally Exists for Financial Planners, but Consumer Protection Issues Remain, GAO-11-235 (Jan. 18, 2011).
12. Advisers Act, Section 202(a)(2) and 202(a)(11)(A).

2. *Certain Professionals*

The definition of "investment adviser" excludes any lawyer, accountant, engineer, or teacher whose performance of investment advisory services is solely incidental to the practice of his or her profession.[13]

3. *Broker-Dealers*

A broker or dealer is not an "investment adviser" if its performance of advisory services is solely incidental to the conduct of its business as a broker or dealer and it receives no special compensation.[14]

Special compensation had generally been interpreted to mean compensation received by the broker other than traditional brokerage commissions or dealer compensation (*i.e.*, mark-ups, mark-downs or similar fees). Changes in the manner in which certain brokers charged compensation for their traditional services raised issues concerning the interpretation of the term "special compensation." In response to these and other changes, the SEC adopted Rule 202(a)(11)-1, which provided an exemption to certain broker-dealers registered under the Securities Exchange Act of 1934 ("Exchange Act") from registration as investment advisers if, among other things, they charged asset-based fees. This Rule was overturned by the U.S. Court of Appeals for the D.C. Circuit in 2007.

In September 2007, the SEC adopted temporary Rule 206(3)-3T to allow registered broker-dealers offering fee-based brokerage accounts to comply with Section 206(3) of the Advisers Act when engaging in principal transactions. (The expiration date for this temporary rule has been extended until December 31, 2016). The temporary rule imposes a number of conditions related to disclosure and client consent.

The SEC also proposed an interpretative rule that would reinstate certain provisions of Rule 202(a)(11)-1, the rule vacated by the D.C. Circuit.[15] The proposed interpretative rule would clarify that:

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13. Advisers Act, Section 202(a)(11)(B).
14. Advisers Act, Section 202(a)(11)(C).
15. Interpretive Rule Under the Advisers Act Affecting Broker-Dealers, SEC Release No. IA-2652 (Sep. 24, 2007).

- a broker-dealer that exercises investment discretion with respect to an account or charges a separate fee, or separately contracts, for advisory services provides investment advice that is not *solely incidental* to its business as a broker-dealer;
- a broker-dealer does not receive special compensation within the meaning of the Advisers Act solely because it charges a commission for discount brokerage services that is less than it charges for full service brokerage; and
- a registered broker-dealer is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subjects it to the Advisers Act.

As required by the Dodd-Frank Act, in 2011 the SEC issued a study of the obligations of brokers, dealers and investment advisers.[16] The study concluded that "retail customers should be protected uniformly when receiving personalized investment advice about securities regardless of whether they choose to work with an investment adviser or a broker-dealer" and recommended that the SEC "adopt and implement, with appropriate guidance, the uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers."

Based on this study, the SEC is expected to engage in rule-making with regard to the harmonization of the fiduciary duties of investment advisers and broker-dealers, but it has not determined whether to commence a rulemaking. On March 1, 2013, the SEC requested "data and other information, in particular quantitative data and economic analysis, relating to the benefits and costs that could result from various alternative approaches regarding the standards of conduct and other obligations of broker-dealers and investment advisers."[17] The SEC intends to address temporary Rule 206(3)-3T (and potentially the proposed interpretative Rule 202(a)(11)-1) as part of this "broader consideration of the regulatory requirements applicable to broker-dealers and investment

16. Study on Investment Advisers and Broker-Dealers As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Jan. 21, 2011).
17. Duties of Brokers, Dealers, and Investment Advisers. SEC Release Nos. 34-69013; IA-3558 (Mar. 1, 2013).

advisers in connection with the Dodd-Frank Act."[18] In March, 2015 the Chair of the SEC, Mary Jo White, said that the SEC should act on a uniform fiduciary standard for brokers and investment advisers that would be based on the fiduciary standard for investment advisers.

4. Publishers

The publisher of any *bona fide* newspaper, news magazine or business or financial publication of general and regular circulation is not an "investment adviser" under the Advisers Act.[19] In *Lowe v. SEC*, 472 U.S. 181 (1985), the Supreme Court held that this exclusion is available for any publisher of a bona fide newsletter of general and regular circulation as long as the newsletter remains "entirely impersonal and do not develop into the kind of fiduciary, person-to-person relationships . . . that are characteristic of investment adviser-client relationships." In *SEC v. Park a/k/a Tokyo Joe et al.,* 99 F. Supp. 2d 889 (N.D. Ill. 2000), one court noted that, even where there is no personal relationship, *Lowe* requires that the publications must be (i) "bona fide" (*i.e.,* containing disinterested commentary and analysis and not promotional material disseminated by a "tout") and (ii) of "general and regular" circulation (*i.e.*, not timing the advice to "specific market activity, or to events affecting or having the ability to affect the securities industry").

The *Tokyo Joe* case involved a website and chat room. The SEC asserted that, under the circumstances of that case, the website did not satisfy the standards of the publisher exclusion. The SEC staff subsequently confirmed that a person who provides advice about securities through a website could fall with the publisher's exclusion provided that the investment advice provided on the website is: (1) of a general and impersonal nature, in that the advice provided is not adapted to any specific portfolio or any client's particular needs; (2) "bona fide" or genuine, in that it contains disinterested commentary and analysis as opposed to promotional material; and (3) of general and regular circulation, in that it is not timed to

18. Temporary Rule Regarding Principal Trades with Certain Advisory Clients, SEC Release No. IA-3483 (Oct. 9, 2012) at fn. 13 and the accompanying text.
19. Advisers Act, Section 202(a)(11)(D).

specific market activity or to events affecting, or having the ability to affect, the securities industry.[20]

5. *Advisers on Certain Exempted Securities*

The definition of "investment adviser" excludes any person whose advice, analyses, or reports relate only to securities which are direct obligations of or obligations guaranteed as to principal or interest by the U.S., or securities issued or guaranteed by corporations, in which the U.S. has a direct or indirect interest, which have been designated by the Secretary of the Treasury as exempted securities for purposes of the Exchange Act.[21]

6. *Rating Agencies*

A nationally recognized statistical rating organization (a "Ratings Agency"), as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934, is not an "investment adviser" unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others.[22]

7. *Family Offices*

The Dodd-Frank Act has added a new exclusion from the definition of "investment adviser" for "family offices."[23]

A "family office" is a company (including its directors, partners, trustees, and employees acting within the scope of their position or employment) that:

- has no clients other than family clients (with a one year grace period for a person who becomes a client due to death or other involuntary transfer);

20. Jonathon Hendricks, SEC No-Action Letter (pub. avail. Jan. 26, 2015) (noting that "[t]he staff has generally declined to express an opinion as to whether a person qualifies for this exclusion, as interpreted by the United States Supreme Court, because this is a factual and not a legal determination.").
21. Advisers Act, Section 202(a)(11)(E).
22. Advisers Act, Section 202(a)(11)(F).
23. Advisers Act, Section 202(a)(11)(G); Rule 202(a)(11)(G)-1.

- is wholly owned and exclusively controlled (directly or indirectly) by family members and/or family entities; and
- does not hold itself out to the public as an investment adviser.

A family client includes (i) any family member (lineal descendants of a specified person and their spouses), (ii) any former family member, (iii) any key employee (executive officers, directors or similar persons who participate in the investment activities of the family office), (iv) any former key employee (subject to certain restrictions), and (v) certain trusts, estates, charitable organizations, or other company of family clients.

The rule contains a "grandfather provision" for family offices that were not registered or required to be registered with the SEC on January 1, 2010 and that provide advice solely to the following grandfathered clients: (A) natural persons who, at the time of their investment, (i) are officers, directors, or employees of the family office, and had invested with the family office before January 1, 2010; and (ii) are accredited investors under Regulation D of the Securities Act of 1933; (B) any company owned exclusively and controlled by one or more family members and (C) registered investment advisers that provide investment advice and identify investment opportunities to the family office and invest in such transactions on substantially the same terms as the family office and meet certain other conditions. In addition, the SEC continues to grant exemptions from Advisers Act registration to family offices that might not comply with all of the conditions of the rule.[24]

Any adviser that relies on the grandfather provision will be subject to the Advisers Act's general anti-fraud provisions.

In adopting the family office rule, the SEC noted that the exclusion for family offices does not extend to family offices serving multiple families ("multi-family office"). The SEC staff has noted that a person who serves as a key employee of multiple family offices could be viewed as creating a multi-family office and thus would not be able to rely on the family office exclusion.[25]

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24. *See* D-W Investments LLC, SEC Rel. No. IA-4066 (Apr. 20, 2015)(notice); SEC Rel. No. IA-4090 (May 19, 2015)(order) (exemption granted to family office whose clients included the sister of the spouse of a lineal descendant of the specified person and an irrevocable trust of which she was the beneficiary, and thus not family members for purposes of the rule).
25. Peter Adamson III, SEC No-Action Letter (pub. avail. Apr. 3, 2012).

8. Other Persons

The SEC may also designate by rules and regulations or order that other persons are not "investment advisers" if such persons are not within the intent of the Advisers Act.[26]

9. Governmental Entities

No provision of the Advisers Act applies to federal or state governments, governmental agencies, or their employees acting as such in the course of their official duties.[27]

III. WHO MUST REGISTER

A. Persons Exempted from Registration

In addition to the exclusions from the definition of "investment adviser" discussed above, the Advisers Act also provides exemptions from the registration requirements of the Advisers Act with regard to certain investment advisers. In general, these exemptions do not apply to investment advisers to investment companies registered under the Investment Company Act ("RICs") and, in certain cases, investment advisers to entities who have elected under the Investment Company Act to become business development companies ("BDCs"), a special type of investment company that invests in small businesses and other companies unable to gain access to the public capital markets.

The Dodd-Frank Act substantially changed the exemptions that are available to investment advisers, particularly to investment advisers of Private Funds. A "Private Fund" is generally defined as a company that would be an investment company but for Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

1. Foreign Private Adviser Exemption

Any investment adviser that is a "foreign private adviser" is exempt from registration under the Advisers Act.[28]

A "foreign private adviser" is defined as an adviser that:

26. Advisers Act, Section 202(a)(11)(H).
27. Advisers Act, Section 202(b).
28. Advisers Act, Section 203(b)(3), Section 202(a)(30) and Rule 202(a)(30)-1.

- has no place of business in the United States;
- has, in total, fewer than 15 clients in the United States and investors in the United States in Private Funds advised by the adviser;
- has aggregate "regulatory assets under management" attributable to U.S. clients and investors in the United States in Private Funds advised by the adviser of less than $25 million; and
- neither holds itself out generally to the U.S. public as an investment adviser, nor acts as an investment adviser to a RIC or a BDC.

"Regulatory assets under management" should be calculated in accordance with Item 5.F of Part 1A of Form ADV, which requires an investment adviser to determine the market value (or fair value) of any securities portfolio to which it provides continuous and regular supervisory or management services. For a Private Fund, this requires the calculation of the fair value of all of the assets of the Private Fund plus the value of any uncalled capital commitments.

An "investor" is:

- any person that would be included in determining the number of beneficial owners of the outstanding securities of a Private Fund under Section 3(c)(1) of the Investment Company Act or whether the outstanding securities of a Private Fund are owned exclusively by qualified purchasers under Section 3(c)(7) of the Investment Company Act; and
- any knowledgeable employee or the holder of short-term paper issued by a 3(c)(1) Fund.

Whether a client or investor is "in the United States" generally depends on whether that person is a "U.S. Person" under Regulation S, except that any discretionary account or similar account that is held for the benefit of a U.S. person by a non-U.S. dealer or other professional fiduciary would be deemed to be "in the United States" if the dealer or professional fiduciary is a related person of the investment adviser relying on the exemption. For example,

- a natural person would be a U.S. person (and therefore "in the United States") if that person is a resident in the United States; and

- a partnership or corporation would be a U.S. person if it is either (i) organized or incorporated under the laws of the United States; or (ii) organized or incorporated under the laws of any foreign jurisdiction and formed by a U.S. person principally for the purpose of investing in securities not registered under the Securities Act of 1933 (e.g., interests in a Private Fund), unless it is organized or incorporated, and owned, by accredited investors who are not natural persons, estates or trusts.

An adviser may treat as a single client:

- a natural person and: (A) that person's minor children; (B) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence; (C) 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 (D) 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,
- 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
- two or more legal organizations that have identical shareholders, partners, limited partners, members, or beneficiaries.

In addition, an adviser would have to count a shareholder, partner, limited partner, member, or beneficiary (each, an "owner") of a corporation, general partnership, limited partnership, limited liability company, trust, or other legal organization, as a client if the adviser provides investment advisory services to the owner separate and apart from the legal organization. The adviser is not required to count an owner as a client solely because the adviser, on behalf of the legal organization, offers, promotes, or sells interests in the legal organization to the owner, or reports periodically to the owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters.

An adviser is not be deemed to be holding itself out generally to the public in the United States as an investment adviser solely because it participates in a non-public offering in the United States of securities issued by a Private Fund.

An adviser exempt under Section 203(b)(3) is subject to certain Advisers Act anti-fraud rules including Rule 206(4)-5 (the "Pay-to-Play Rule") and Rule 206(4)-8 (addressing fraud by advisers who defraud investors and potential investors in pooled investment vehicles).

2. Intrastate Adviser

An investment adviser does not need to register under the Advisers Act if all of its clients are residents of the state within which such investment adviser maintains a principal office and place of business, unless the adviser:

- furnishes advice or issues analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange; or
- acts as an investment adviser to any Private Fund.[29]

3. Insurance Company Advisers

Any investment adviser whose only clients are insurance companies does not need to register under the Advisers Act.[30] Because the definition of "insurance company" could be interpreted to include only domestic insurance companies, the SEC staff has provided no-action relief from registration under the Advisers Act to investment advisers who also provide investment advice to foreign insurance companies that meet the requirements of Rule 3a-6 of the Investment Company Act.[31]

4. CFTC-Registered Adviser

An investment adviser does not need to register under the Advisers Act if it is registered with the Commodity Futures Trading Commission (the "CFTC") as a commodity trading advisor whose business does not consist primarily of acting as an investment adviser unless

29. Advisers Act, Section 203(b)(1).
30. Advisers Act, Section 203(b)(2).
31. TACT Asset Management Inc., SEC No-Action Letter (pub. avail. Oct. 24, 2012).

- the adviser acts as an investment adviser to any RIC or any BDC; or
- the adviser is an adviser to a Private Fund and the adviser's business has become predominantly the provision of securities-related advice after July 21, 2010.[32]

The SEC staff has clarified that a CFTC-registered investment adviser to a Private Fund may not rely on this exemption if either (i) it advises a RIC or BDC (in addition to a Private Fund) or (ii) its business was predominantly the provision of securities-related advice prior to July 21, 2010 and remains so after July 21, 2010.[33]

5. SBIC Advisers

An investment adviser, who is not a BDC, does not need to register under the Advisers Act if it solely advises:

- small business investment companies that are licensees under the Small Business Investment Act of 1958 (the "Small Business Investment Act");
- entities that have received notice to proceed to qualify as a small business investment company under the Small Business Investment Act; and
- affiliates of the entities described in the first clause who have a pending application to be licensed under the Small Business Investment Act.[34]

A recent amendment to the Advisers Act (the "FAST Act", discussed below) preempts states from requiring advisers relying on the SBIC advisers exemption to register with the state. Although SBIC advisers may remain subject to SEC and state regulatory authority for anti-fraud purposes, they are not required to register or report at either the state or federal level.

32. Advisers Act, Section 203(b)(6).
33. Investment Advisers Registered with the Commodity Futures Trading Commission ("CFTC") that Advise Private Funds, Investment Management Staff Issues of Interest, http://www.sec.gov/divisions/investment/issues-of-interest.shtml#cftc (viewed on May 13, 2013).
34. Advisers Act, Section 203(b)(7).

6. *Venture Capital Fund Adviser Exemption*

An investment adviser does not need to register under the Advisers Act if the adviser acts as an investment adviser solely to one or more "venture capital funds."[35]

A "venture capital fund" is a Private Fund that satisfies the following requirements:

- The fund must be represented to investors as pursuing a venture capital strategy.
- Immediately after the acquisition of any asset (other than a qualifying investment or a short-term holding), the fund must hold no more than 20% of the fund's aggregate capital contributions and uncalled capital in assets that are not qualifying investments or short-term holdings. A "qualifying investment" is generally an equity security issued by (and acquired directly from) a qualifying portfolio company (and certain equity securities issued in exchange for such equity securities). A "qualifying portfolio company" is generally a private company that (i) is not an investment company, securitization vehicle, Private Fund or commodity pool and (ii) has not borrowed or issued debt obligations in connection with the fund's investment and distributed to the private fund the proceeds of such borrowing or issuance in exchange for the fund's investment.[36]
- The fund's borrowings must be (i) limited to less than or equal to 15 percent of the fund's aggregate capital contributions and uncalled committed capital and (ii) for a non-renewable term of no longer than 120 calendar days (excluding any guarantee by the fund of a qualifying portfolio company's obligations up to the value of the fund's investment in the portfolio company).
- The investors in the fund may only withdraw from the fund or redeem their interests in extraordinary circumstances.
- The fund may not be RIC or BDC.

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35. Advisers Act, Section 203(l); Rule 203(l)-1.
36. In a recent no-action letter, the SEC staff addressed a number of scenarios where certain of the rule's provisions did not appear to work as intended, particularly in the context of the application of the "qualifying portfolio company" definition. *See* Willkie Farr & Gallagher LLP, SEC No-Action Letter (pub. avail. Sept. 21, 2015) (addressing the operation of the rule in the context of companies under common control with portfolio companies that are public companies).

In addition, as a result of a 2015 amendment to the Advisers Act contained in the Fixing America's Surface Transportation Act (the "FAST Act"), a "venture capital fund" also includes a small business investment company and certain related entities described in Section 203(b)(7) of the Advisers Act (providing an exemption to SBIC advisers as described above).[37] As a result of this amendment, an adviser whose only clients are rule 203(l)-1 venture capital funds and/or SBICs may rely on the venture capital fund adviser exemption.

7. Private Fund Adviser Exemption

Certain advisers to Private Funds are exempt from registration under the Advisers Act.[38] The availability of this exemption is based on whether the adviser's principal place of business is in the United States (a "U.S. Adviser").

For a U.S. Adviser, (i) the adviser must act as investment adviser solely to Private Funds and (ii) the regulatory assets under management of the adviser (managed from any office wherever located) must be less than $150 million. An investment adviser relying on this exemption is required to calculate its regulatory assets under management annually.

For a Non-U.S. Adviser, (i) the adviser must have no client that is a U.S. person other than a Private Fund and (ii) the regulatory assets under management of the Private Funds managed by the adviser from a place of business in the United States must be less than $150 million.

Note that a Non-U.S. Adviser with no place of business in the United States, that does not provide investment advice with regard to any U.S. person who is not a Private Fund, would be exempt from registration under this provision, regardless of the amount of money it manages that is attributable to U.S. investors in Private Funds.

For a Non-U.S. Adviser with a place of business in the United States, the key determination will be whether the adviser provides continuous and regular supervisory or management services from that place of business. The SEC has stated that "continuous and regular supervisory or management services" would not include

37. Fixing America's Surface Transportation Act, Pub. L. No. 114-94, §§74001-74003, 129 Stat. 1312, 1786-1787 (2015) (the "FAST Act").
38. Advisers Act, Section 203(m); Rule 203(m)-1.

situations where the adviser provides research or conducts due diligence at a U.S. place of business if a person outside of the United States makes independent investment decisions and implements those decisions.[39]

"Regulatory assets under management" should be calculated in accordance with Item 5.F of Part 1A of Form ADV, which requires an investment adviser to determine the market value (or fair value) of any securities portfolio to which it provides continuous and regular supervisory or management services. For a Private Fund, this requires the calculation of the fair value of all of the assets of the Private Fund plus the value of any uncalled capital commitments.

The FAST Act revised this exemption by excluding SBIC assets from counting towards the $150 million threshold. As a result, an adviser that has assets under management in the United States of less than $150 million attributable to its non-SBIC private fund clients may rely on the private fund adviser exemption regardless of the assets under management in the United States attributable to its SBIC client(s).[40]

> Investment advisers that rely on either the Venture Capital Fund Adviser Exemption (described in III.A.6) or the Private Fund Adviser Exemption (described in III.A.7) are considered "exempt reporting advisers." Exempt reporting advisers are subject to a certain amount of Advisers Act regulation and SEC oversight.
>
> As a result of the FAST Act, it is the view of the SEC staff that an adviser currently relying on the SBIC adviser exemption and advising only SBICs may choose to instead: (1) rely on the venture capital fund adviser exemption and advise both SBICs and venture capital funds; or (2) rely on the private fund adviser exemption and advise both SBICs and non-SBIC private funds, provided those non-SBIC private funds account for less than $150 million in regulatory assets under management. However, unlike an adviser relying on the SBIC adviser

39. Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (Jun. 22, 2011) at 99.

40. Advisers Act, Section 203(m)(3). *See also*, FAST Act Changes Affecting Investment Advisers to Small Business Investment Companies, IM Guidance 2016-3 (Mar. 2016) ("IM Guidance 2016-3").

exemption, the staff believes that an SBIC adviser that chooses to rely on either the venture capital fund adviser exemption or the private fund adviser exemption is required to submit reports to the Commission as an exempt reporting adviser. See IM Guidance 2016-3.

Exempt reporting advisers are required to file an abbreviated Form ADV but are not required to file Form PF (the systemic risk-related Private Fund reporting form).

Exempt reporting advisers are subject to the anti-fraud provisions of the Advisers Act and certain Advisers Act anti-fraud rules including Rule 206(4)-5 (the Pay-to-Play Rule) and Rule 206(4)-8 (addressing fraud by advisers who defraud investors and potential investors in pooled investment vehicles).

The SEC may examine exempt reporting advisers; although, it does not expect to subject exempt reporting advisers to routine examinations due to resource constraints. The SEC staff may conduct "for cause" examinations where it has some indication that a violation of law may be occurring due to, for example, an investor complaint.

Exempt reporting advisers may also be subject to a rule relating to books and records; however, the SEC has not proposed any such rule.

B. Advisers to Pension Plans

As a practical matter, advisers to certain pension plans must be registered either with the SEC or with a state regulator. The additional requirements that may be imposed by ERISA are beyond the scope of this outline.

C. Dual-Registration with CFTC

If an adviser provides advice to others on commodities or futures, registration with the Commodity Futures Trading Commission may also be required. The additional requirements that may be imposed by the Commodity Exchange Act, as amended, are beyond the scope of this outline.

IV. STATE REGISTRATION AND REGULATION

In a significant rebalancing of federal (SEC) and state responsibility for the regulation of investment advisers, the National Securities Markets

Improvement Act of 1996 ("NSMIA") generally preempted state regulation of investment advisers that have $25 million or more in assets under management or that advise registered investment companies.[41] The Dodd-Frank Act raised this dividing line to $100 million or more assets under management if the adviser is subject to registration and examination as an investment adviser by the state's relevant agency.

The remaining advisers are generally exempt from SEC registration and left principally subject to regulation by the states in which they maintain their principal office and place of business.

States may continue to investigate and bring enforcement actions against SEC-registered investment advisers for fraud or deceit, to require advisers to consent to service of process, to require certain filings and the payment of fees by investment advisers, and to license adviser representatives and solicitors.[42]

The interplay of the federal and state registration requirements is beyond the scope of this outline.

V. AFFILIATES AND ASSOCIATED PERSONS

A. Registration of Associated Persons Not Required

Persons associated with a registered investment adviser (*i.e.*, the adviser's officers, directors, and employees) are not themselves required to register, but their identity, business, and educational background generally must be disclosed in Form ADV (the federal registration form) and in most state registration documents.

B. Registration of Affiliates

1. Independent Subsidiaries

For many years, the SEC staff took the strict view that a parent company (whether or not based in the U.S.) that provided investment advisory services through a subsidiary would be required to register as an investment adviser (unless exempt from registration) even if its subsidiary was a registered investment adviser—unless the registered subsidiary had a separate independent existence that functioned independently of its parent. The SEC staff set forth certain "safe harbor" guidelines to ensure that the subsidiary was

41. Advisers Act, Section 203A(a)(1)(A).
42. Advisers Act, Section 203A(b)(2).

something more than a shell corporation serving as only a conduit for investment advice emanating from elsewhere. Under these guidelines, described in Richard Ellis, Inc., SEC No-Action Letter (pub. avail. Sept. 17, 1981), a subsidiary entity is regarded as having a separate independent existence and functioning independently of its parent if it:

- is adequately capitalized;
- has a buffer, such as a board of directors a majority of whose members are independent of the parent, between the subsidiary's personnel and the parent;
- has employees, officers, and directors who, if engaged in providing investment advice in the day-to-day business of the subsidiary entity, are not otherwise engaged in the investment advisory business of the parent;
- itself makes the decision as to what investment advice is to be communicated to or is to be used on behalf of its clients and has and uses sources of investment information not limited to its parent; and
- keeps its investment advice confidential until communicated to its clients.

2. *Subsidiaries Sharing Personnel with a Parent*

In Unibanco-União de Bancos Brasileiros SA, SEC No-Action Letter (pub. avail. July 28, 1992), the SEC staff modified its position regarding the requirement for strict separation between a parent and a subsidiary. In addition, the SEC staff modified its views concerning the extraterritorial application of the Advisers Act. The SEC staff in *Unibanco* gave non-U.S. advisers greater flexibility to establish registered investment adviser subsidiaries without themselves being required to register. The SEC staff will not require a non-U.S. parent to register if its subsidiary registers as an investment adviser, provided that:

- the affiliated companies are separately organized (*e.g.*, two distinct entities);
- the registered entity is staffed with personnel (whether physically located in the U.S. or abroad) who are capable of providing investment advice;

- all employees of the parent company who are involved in U.S. advisory activities are "associated persons" of the registrant; and
- the SEC has adequate access to trading and other records of each affiliate involved in U.S. advisory activities and its personnel, to the extent necessary to monitor and police conduct that may harm U.S. persons or markets.[43] The no-action relief in these letters is subject to a number of important conditions.

Similarly, the SEC staff has confirmed that a foreign affiliate of a U.S.-based registered investment adviser need not be registered if similar conditions are satisfied.[44]

3. Affiliates Other than Parent Companies

In Mercury Asset Management plc, SEC No-Action Letter (pub. avail. Apr. 16, 1993), the SEC staff first applied the separateness test in *Unibanco* (described above) to non-U.S. companies that are affiliated due to common ownership or control.

VI. EXTRATERRITORIAL APPLICATION

A. General

Historically, the SEC staff made broad claims as to the extraterritorial application of the Advisers Act and the SEC's own jurisdiction with respect to SEC-registered advisers. For example, in Gim-Seong, SEC No-Action Letter (pub. avail. Nov. 30, 1987), the staff stated: "We . . . wish to point out that, generally speaking, all U.S. registered advisers (domestic and foreign) are subject to the relevant substantive provisions of the Advisers Act with respect to both U.S. and non-U.S. clients." However, since 1992, the staff has

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43. *See also* Mercury Asset Management plc, SEC No-Action Letter (pub. avail. Apr. 16, 1993); Kleinwort Benson Investment Management Limited, SEC No-Action Letter (pub. avail. Dec. 15, 1993); Murray Johnstone Holdings Limited, SEC No-Action Letter (pub. avail. Oct. 7, 1994); Thomson Advisory Group L.P., SEC No-Action Letter (pub. avail. Sept. 26, 1995); ABN-AMRO Bank N.V., SEC No-Action Letter (pub. avail. July 1, 1997); Royal Bank of Canada, SEC No-Action Letter (pub. avail. June 3, 1998).
44. ABA Subcommittee on Private Investment Entities, SEC No-Action Letter (pub. avail. Dec. 8, 2005).

adopted a narrower approach regarding the application of the Advisers Act to foreign advisers and their non-U.S. clients.

In *Unibanco* (described above), the staff first applied the Advisers Act to foreign advisers on the basis of a "conduct and effects test," i.e., only where an adviser's activity involves conduct occurring in the U.S. or produces substantial and foreseeable effects in the U.S. will the Advisers Act apply.

B. Application of Registration Requirements to Non-U.S. Advisers

Unless excluded from the definition of investment adviser or exempted from registration as described above, a non-U.S. investment adviser that makes use of U.S. jurisdictional means to solicit, or provide advisory services to, persons resident in the U.S. must register under the Advisers Act. This is the case even if the adviser has less than $25 or $100 (as applicable) million in assets under management. However, a small non-U.S. investment adviser that maintains a place of business and office in a state would be subject to state regulation.

A non-U.S. adviser to non-U.S. clients may, however, use U.S. jurisdictional means to acquire information about the securities of U.S. issuers, and effect transactions in the securities of U.S. issuers through U.S. brokers or dealers, for the benefit of the adviser's non-U.S. clients without registering under the Advisers Act. The SEC and its staff have stated that the substantive provisions of the Advisers Act will not apply to a registered non-U.S. adviser's dealings with its non-U.S. clients.[45] The non-U.S. adviser will, however, be required to keep certain books and records pertaining to its non-U.S. clients and make them available to the SEC upon request.

45. American Bar Ass'n, SEC No-Action Letter (pub. avail. Aug. 10, 2006). *See also* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, SEC Release No. IA-3222 (Jun. 22, 2011)(adopting release) at fn. 515 and the accompanying text.

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