Implications of Recent Amendments to the U.S. Investment Advisers Act for Non-U.S. Investment Advisers, Part I

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President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") into law on July 21, 2010, ending a two-year struggle to pass legislation framing the U.S. response to the global financial crisis that began in 2008. The Dodd-Frank Act will make the most sweeping changes since the 1930s in the way the U.S. financial system is supervised and regulated. The new law seeks to address the underlying causes of the crisis and to modernize the legal and regulatory framework that governs the ever more complex network of financial institutions known, to supporters and critics alike, as Wall Street.

Title IV of the Dodd-Frank Act, codified as the Private Fund Investment Advisers Registration Act of 2010, revises the U.S. Investment Advisers Act of 1940, as amended (the "**Advisers Act**"), fundamentally altering the regulatory terrain for investment advisers to private funds. In this new environment, many non-U.S. investment advisers who previously were exempt from registration under the Advisers Act will be forced to register and to bear the costs of complying with an expanded set of applicable requirements. Certain non-U.S. investment advisers, however, may be eligible for exemptions from registration.

Key Issues

Investment advisers to private funds as targets of financial reform

It may be true that private funds bear no part of the blame for the global financial crisis and that their very "privacy" has made them convenient scapegoats for politicians seeking to exploit the suspicions of an anxious public. On the other hand, the Dodd-Frank Act's broadening of registration requirements under the Advisers Act may reflect a legitimate concern on the part of the U.S. Congress that private funds — especially hedge funds — pose a systemic risk given the extent of their participation in various financial markets, the range of their trading activities and the size of their own and their counterparties' credit exposures. Concerns about financial stability have been coupled with a belief that the regulatory authorities have too little information about private funds and their advisers to make reliable assessments of systemic risk.

From this perspective, the Dodd-Frank Act represents an attempt to close gaps in the regulations affecting investment advisers to private funds brought about by narrowing the exemptions available under the Advisers Act as well as the U.S. Securities Act of 1933, as amended, and the U.S. Investment Company Act of 1940, as amended (the "**1940 Act**"). The Dodd-Frank Act effectively expands the jurisdiction of the U.S. Securities and Exchange Commission (the "**SEC**") over investment advisers to private funds, giving the SEC greater access to information through enhanced recordkeeping and disclosure requirements applicable to both registered and unregistered investment advisers. In particular, the new law extends Advisers Act registration requirements to many non-U.S. investment advisers who previously qualified for an exemption.

Registration and exemptions from registration under the Advisers Act

The Advisers Act and the related SEC rules generally require investment advisers, unless an exemption is available, to register with the SEC. Both

If you would like to know more about the subjects covered in this publication or our services, please contact:

Jeff Berman +1 212 878 3460

Ilomai Kurrik +1 212 878 3356

Steven Gatti +1 202 912 5095

Clifford Cone +1 212 878 3180

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

registered and unregistered investment advisers are subject to the anti-fraud provisions of the Advisers Act and certain recordkeeping and reporting requirements, although registered advisers face more stringent information requirements and are subject to periodic SEC examination (which will be discussed in detail in Part II of this article). Under the current Advisers Act regime, many non-U.S. "private" investment advisers have relied on an exemption in order to avoid registering with the SEC. The available exemptions will be eliminated or greatly narrowed once the Dodd-Frank Act becomes effective and the SEC revises its Advisers Act rules.

Repeal of the "private adviser" exemption

Currently, many U.S. and non-U.S. investment advisers avoid Advisers Act registration by relying on the so-called "private adviser" exemption (the "**Original Private Adviser Exemption**"), which will be repealed as of July 21, 2011, the effective date of Title IV of the Dodd-Frank Act. The Original Private Adviser Exemption has been available to any investment adviser that has advised fewer than 15 "clients" during the previous 12 months and does not hold itself out to the public as an investment adviser.[1] Any private fund that the investment adviser manages is counted as only one "client" for purposes of the exemption; the fund's underlying *investors* need not be counted in determining whether the adviser has fewer than 15 clients. Thus an investment adviser that manages fewer than 15 different private funds has been able to rely on the Original Private Adviser Exemption and, in fact, the exemption has been widely used by both U.S. and non-U.S. investment advisers whose businesses focus on private fund management.[2]

In 2004, the SEC changed its longstanding view and issued a rule requiring, in the case of certain private funds (principally hedge funds), the underlying investors in the fund to be counted in determining how many clients the fund's investment adviser has for purposes of the Original Private Adviser Exemption. Subsequently, in *Goldstein v. SEC*, a U.S. federal appeals court invalidated the rule and ridiculed the SEC's interpretation of the Advisers Act to permit underlying investors in a private fund to be treated as "clients" of the fund's investment adviser. Although the SEC failed in the attempt to use its rulemaking authority to limit the scope of the Original Private Adviser Exemption, the basic idea — that "looking through" a private fund to its underlying investors in determining whether the exemption is available to the fund's investment adviser would, somehow, help the SEC assess whether private funds pose a systemic risk — became a persistent theme in discussions of regulatory reform. The Dodd-Frank Act goes beyond merely limiting the ability of investment advisers to private funds to use the Original Private Adviser Exemption; it eliminates the exemption entirely.

Enactment of the "foreign private adviser" exemption

The Dodd-Frank Act provides an exemption from registration under the Advisers Act for any "foreign private adviser" (the "**Foreign Private Adviser Exemption**"). Although the Foreign Private Adviser Exemption bears some resemblance to the Original Private Adviser Exemption, it is far more narrowly drawn. An eligible "foreign private adviser" is defined to mean any investment adviser who:

(A) has no place of business in the United States;

(B) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; [3]

(C) has aggregate assets under management ("**AUM**") attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser of less than $25 million (or any higher amount specified by the SEC); and

(D) does not hold itself out generally to the public in the United States as an investment adviser.[4]

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[1] An investment adviser relying on the Original Private Adviser Exemption also may not act as an investment adviser to any investment company registered under the 1940 Act or any entity electing to be treated as a business development company ("**BDC**") under the 1940 Act.

[2] Under the definition of "client" in SEC Rule 203(b)(3)-1, an investment adviser with a principal office and place of business outside the United States has been permitted to disregard not only investors in any private funds that it manages, but also any clients — including private funds — that are not themselves U.S. residents.

[3] As amended by the Dodd-Frank Act, the Advisers Act defines "private fund" to mean a fund that would be an investment company under the 1940 Act but for the exemptions provided by Sections 3(c)(1) and 3(c)(7) — the "not more than 100 owners" and "qualified purchasers only" exemptions, respectively, under the 1940 Act.

[4] A foreign private adviser also may not act as an investment adviser to any registered investment company or BDC under the 1940 Act.

The "foreign" component of the Foreign Private Adviser Exemption seems clear from the above clauses (A) and (D): to be eligible, an investment adviser may not have *any* place of business in the United States, nor may it hold itself out generally to the public in the United States as an investment adviser. To the contrary, we believe a close reading of clauses (B) and (C) — while painful — reveals ambiguities and other problems in the numerical and AUM components of the Foreign Private Adviser Exemption that will need to be resolved, presumably through SEC rulemaking.

The numerical test

Clause (B) requires an investment adviser to have, in total, "fewer than 15 clients and investors in the United States in private funds advised by the investment adviser" in order to be eligible for the Foreign Private Adviser Exemption. It is at first tempting to read the prepositional phrase "in the United States in private funds advised by the investment adviser" as modifying not only "investors" but also "clients" — so that clients are counted for purposes of the exemption's numerical test only if they are in the United States and "in" private funds advised by the investment adviser. But "clients" and "investors" are not so easily interchangeable in the post-*Goldstein* world. The Dodd-Frank Act may have eliminated the Original Private Adviser Exemption, yet it left undisturbed the *Goldstein* court's conclusion that in the case of investment advisers to private funds, the client is the fund, and investors in the fund are merely bystanders. Congress plainly intended that investors in private funds managed by an investment adviser should be counted separately from and in addition to the investment adviser's clients. We believe the numerical test of the Foreign Private Advisor Exemption requires the sum of (i) an investment adviser's "clients" *plus* (ii) "investors in the United States in private funds advised by the investment adviser" to equal fewer than 15.

The ambiguity arises when the implications of reading the Foreign Private Advisor Exemption this way are considered. First, because an investment adviser's clients include the private funds that the adviser manages, the exemption appears to require counting *both* the private fund vehicles *and* their U.S. investors for purposes of the numerical test — a case of double counting, in contrast to the usual "look-through" rule in which the subject entity is simply disregarded. Second, and more troubling, although an investment adviser is required to have no place of business in the United States in order to be eligible for the Foreign Private Adviser Exemption, the exemption requires on its face that the adviser's clients be counted whether or not they are U.S. residents.

Counting a non-U.S. investment adviser's non-U.S. clients is directly contrary to the SEC's historical position under Section 203(b)(3) of the Advisers Act, the Original Private Adviser Exemption. In 1985, the SEC issued Rule 203(b)(3)-1 which, among other things, permits an investment adviser with its principal office and place of business outside the United States to disregard clients that are not U.S. residents.[5] Because Rule 203(b)(3)-1 implements Section 203(b)(3) of the Advisers Act, it seems reasonable to expect that the SEC will no longer regard the Rule as valid once Title IV of the Dodd-Frank Act becomes effective and Section 203(b)(3) in its current form is repealed. There is no apparent rationale, however, for Congress to deny investment advisers with no place of business in the United States the benefits of Rule 203(b)(3)-1 and to require that their non-U.S. clients be counted for purposes of the Foreign Private Adviser Exemption. The SEC should be urged to clarify the matter as it considers proposed rules under the amended Advisers Act.

The AUM test

The AUM component of the Foreign Private Adviser Exemption (clause (C) above) requires an investment adviser to have AUM "attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser" of less than $25 million (or any higher amount specified by the SEC) in order to be eligible for the Foreign Private Adviser Exemption. This language is unambiguous, at least, with no confusion of "clients" and "investors" and no requirement that AUM attributable to non-U.S. clients be counted.

In the case of the AUM test, the problem is the absurdly low ineligibility threshold. At less than $25 million of AUM attributable to the United States, it appears likely that an investment adviser would almost always exceed the AUM ceiling before getting close to the numerical test's "fewer than 15" cap — particularly with the larger institutional and family office investors that comprise the typical non-U.S. investment adviser's target audience in the United States. The less-than-$25 million AUM ceiling, in short, threatens to make the Foreign Private Adviser Exemption all but useless to the vast majority of non-U.S. investment advisers.

Perhaps recognizing the problem, Congress added language to the Foreign Private Adviser Exemption authorizing the SEC to increase the less-than-$25 million AUM cap to "such higher amount as the [SEC] may, by rule, deem

[5] Clients that are private funds may be disregarded if their principal office and place of business is outside the United States. *See* Investment Advisers Act Release No. 2333, footnote 201 (December 2, 2004).

appropriate in accordance with the purposes of this title." The prospects for such an increase are unclear, however, given the chilly regulatory reception likely to meet any attempt to liberalize available exemptions for investment advisers. SEC Chairman Mary Schapiro has said that the SEC supports expanded registration of private fund advisers and intends to "work with Congress to avoid creating broad new carve-outs or exceptions that could come back to haunt investors in later years."[6] Notwithstanding Chairman Schapiro's statement, the SEC should be urged to raise the AUM ceiling in the initial set of rule proposals under the amended Advisers Act.

Other exemptions potentially available to non-U.S. advisers

Notwithstanding the new regime, registration is not a foregone conclusion for non-U.S. investment advisers. The Dodd-Frank Act does create some additional exemptions that may be available to non-U.S. investment advisers, and makes relatively slight modifications to other existing exemptions.

Advisers to venture capital funds

The Dodd-Frank Act amends the Advisers Act by adding an exemption to the registration requirements of the Advisers Act, subject to limited recordkeeping and reporting requirements to be determined by the SEC,[7] for investment advisers to one or more venture capital funds (and solely to such venture capital funds). There is no maximum AUM attributable to the advised venture capital funds for the exemption to apply. The SEC would be required to issue final rules to define the term "venture capital fund" by July 21, 2011. Apparently, Congress liked the sound of an exemption for advisers to venture capital funds enough to leave the actual definition to the regulators, and so the scope of the exemption will be unclear until proposed regulations are issued.

Advisers to small private funds

The Dodd-Frank Act amends the Advisers Act by adding an exemption to the registration requirements of the Advisers Act, subject to limited recordkeeping and reporting requirements to be determined by the SEC, for investment advisers to one or more private funds (and solely to such private funds). The exemption would only apply if AUM in the United States attributable to the advised private funds is, in the aggregate, less than $150 million — significantly higher than the less-than-$25 million AUM ceiling under the Foreign Private Adviser Exemption. Some non-U.S. advisers unable to qualify under the less-than-$25 million dollar ceiling might be able to avoid registration through the small private fund adviser exemption.

The small private fund adviser exemption and the venture capital fund adviser exemption are less advantageous, however, insofar as both exemptions require an investment adviser to act "solely" as an adviser to private funds or venture capital funds, as applicable. Thus these exemptions are not available to an investment adviser who, for example, also manages separate accounts for clients.

Commodity trading advisers

The current Advisers Act exemption for commodity trading advisers, on which many non-U.S. investment advisers rely, was left largely untouched by the Dodd-Frank Act. An investment adviser that is registered with the Commodity Futures Trading Commission (the "**CFTC**") as a commodity trading adviser and whose business does not consist *primarily* of acting as an investment adviser is exempt from SEC registration.[8] In addition, the Dodd-Frank Act created a new exemption for investment advisers registered with the CFTC as commodity trading advisers and who advise a private fund, provided that if the business of such an investment advisor becomes *predominately* the provision of securities-related advice, then the adviser is required to register with the SEC under the Advisers Act. The precise scope of this conditional exemption for commodity trading advisers who provide certain investment advice to private funds will not be clear until proposed regulations are issued by the SEC.

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[6] Speech at SIFMA Annual Conference, New York, October 27, 2009.

[7] Although venture capital fund advisers are to be exempt from registration, the Dodd-Frank Act provides that the SEC "shall require such advisers to maintain such records and provide to the [SEC] such annual or other reports as the [SEC] determines necessary or appropriate in the public interest or for the protection of investors."

[8] An investment adviser relying on the commodity trading adviser exemption also may not act as an investment adviser to any registered investment company or BDC under the 1940 Act.

Conclusion

Although various other, narrower exemptions may be available to non-U.S. investment advisers, the Dodd-Frank Act spelled the end of the "private adviser" exemption on which most non-U.S. advisers have long relied, likely requiring many previously unregistered non-U.S. investment advisers to register with the SEC and become accustomed to a host of additional regulatory requirements under the Advisers Act. In addition to new responsibilities regarding custody and disclosure (to be discussed in Part II of this article), the Dodd-Frank Act adds to registered investment advisers' obligations to maintain records, file reports and make available information regarding private funds they advise, all as deemed necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk. As Congress has chosen to limit the exemptions available and materially increase the burdens of registration for non-U.S. investment advisers, the consequences of the Dodd-Frank Act may well include a reduction in opportunities for U.S. investors to participate in pooled investment vehicles managed by non-U.S. investment advisers.

The new Advisers Act exemption for "foreign private advisers" is very narrowly drawn and will be of limited usefulness to non-U.S. investment advisers unless and until the SEC resolves ambiguities in the exemption's language and adjusts an unrealistically low ceiling on assets under management. As matters currently stand, the Dodd-Frank Act represents a setback in efforts to promote international regulatory cooperation. It needlessly expands the SEC's extra-territorial reach to include the non-U.S. clients of non-U.S. investment advisers, while at the same time making it virtually impossible for unregistered foreign private advisers — many of whom are subject to comparable supervision by home-country regulatory authorities — to grow their business with U.S. clients. The shape of the U.S. investment management sector for years to come may well be determined by the SEC rulemaking process over the next 12 months, a process in which we believe the global investment adviser community must play a critical role.

Summer law clerk Jeffrey D. Hamilton assisted in the preparation of this article.