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May 16, 2011

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: The Extraterritorial Application of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to Non- U.S. Advisers to Offshore Private Funds; SEC File No. S7-37-10

Ladies and Gentlemen:

Attached is an article I wrote discussing the application of Title IV of Dodd-Frank, The Private Fund Investment Advisers Act of 2010 (the "Act"), to non-U.S. advisers to private investment funds. The article has been submitted to *The Hedge Fund Journal* in London for publication in its June 2011 issue.

The article addresses, among other things, the issue of the extraterritorial application of the Act to non-U.S. advisers to offshore funds who do not satisfy the requirements for the foreign private adviser exemption because of the number of U.S. investors in the offshore funds that they manage or the amount of assets invested by U.S. investors in those funds. (*See* pages 3-7.) The views expressed in the article are mine and not necessarily those of Katten Muchin Rosenman LLP. However, the article does develop a point made by Katten in a comment letter it submitted to the Commission on January 24, 2011.

It is my understanding that the Commission is considering the extraterritoriality issue raised in the Katten comment letter and expects to address it in the final regulations under the Act. Although the period for comment on the proposed regulations has closed, I am submitting the article in the hope that it may still be of some assistance to the Commission in that process.

Sincerely,

Jack Governale

Jack Governale

Application of the U.S. Private Fund Investment Advisers Registration Act of 2010 to Non-U.S. Advisers to Private Investment Funds

By Jack Governale, Esq.[1]

The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* ("Dodd-Frank")[2] was enacted last summer to considerable fanfare. Many of its most sweeping reforms have yet to take effect and key regulations necessary to implement them are still working their way through the regulatory process.[3] Of particular relevance to the private investment funds industry is Title IV of Dodd-Frank, *The Private Fund Investment Advisers Registration Act of 2010* (the "Act"),[4] which amended the provisions of the U.S. Investment Advisers Act of 1940 (the "Advisers Act") relating to the registration of, and the recordkeeping and reporting obligations imposed on, investment advisers. Those amendments change dramatically the way the U.S. regulates investment advisers. Although it is now almost certain that the date for compliance with the Act will be pushed back from July 21 of this year to sometime in the first quarter of 2012,[5] complacency would be misguided. Given the scope and complexity of the changes made by the Act, and the potential burdens of complying with it, advisers need to determine sooner rather than later what effect, if any, the Act will have on their operations.

This article discusses the impact of the Act on non-U.S. advisers[6] to "private funds," which are broadly defined as any fund that would be an investment company under the Investment Company Act of 1940 but for Sections 3(c)(1) or 3(c)(7) of such act.[7] This definition

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[2] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] On November 19, 2010, the Securities and Exchange Commission proposed rules implementing various aspects of the Act. *See,* SEC Release No. IA-3110 and SEC Release No. IA-3111. As of this writing, the final implementing regulations had not been issued. In a letter to the North American Securities Administrators Association dated April 8, 2011, Robert E. Plaze, the Associate Director of the Securities and Exchange Commission's Division of Investment Management, stated that the Commission anticipated issuing its final regulations under the Act in advance of the July 21 effective date of the Act (the "Plaze Letter").

[4] Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376, §§401-419.

[5] *See* the Plaze Letter ("given the time needed for advisers to register and come fully into compliance with the obligations applicable to them once they are registered, we expect that the Commission will consider extending the date by which these advisers must register and come into compliance with the obligations of a registered adviser until the first quarter of 2012.") As of this writing, the Commission has not formally taken any steps to postpone compliance with the Act beyond its July 21 effective date.

[6] As used herein, a non-U.S. adviser is an adviser that has its principal office and place of business (*i.e.*, the place where it controls, or has ultimate responsibility for, the management of its clients' assets) outside the U.S. *See Uniao de Bancos de Brasileiros, S.A.*, SEC No-Action Letter (July 28, 1992), and *Richard Ellis*, SEC No-Action Letter (September 17, 1981) for a discussion relating to circumstances under which the activities of a U.S. affiliate of a non-U.S. adviser can be attributed to the non-U.S. adviser.

[7] Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376, §402(a). An "investment company" is defined in the Investment Company Act as any entity that, *inter alia*, (i) holds itself out as being engaged primarily in the business of investing, reinvesting or trading in securities, or (ii) is engaged or proposes to engage in the business of investing,

captures hedge funds, private equity funds and venture capital funds formed in the United States and offshore hedge funds, private equity funds and venture capital funds that have U.S. investors.[8]

Introduction

The Advisers Act currently exempts an investment adviser from registering with the Securities and Exchange Commission (the "SEC") if the adviser has had fewer than fifteen clients during the past twelve months and does not hold itself out generally to the public as an investment adviser or provide investment advice to a registered investment company.[9] In applying this so-called "private adviser" exemption, a U.S.-based adviser counts all of its advisory clients, wherever located, while a non-U.S. adviser that does not maintain an office in the U.S. counts only its U.S. advisory clients. Moreover, an adviser to private investment funds counts each fund as a single advisory client if the fund receives investment advice based on its investment objectives and not the individual investment objectives of its investors.[10]

Because the current private adviser exemption is available without regard to the amount of assets the adviser has under management, a non-U.S. adviser with *fewer* than fifteen U.S. clients over a twelve-month period is exempt from registration even if it manages billions of dollars for those U.S. clients, whereas a non-U.S. adviser with fifteen or more U.S. clients is required to register regardless of the amount of assets it manages.[11]

The breadth of the private adviser exemption under current law has made federal registration of advisers to private investment funds largely voluntary. To be sure, as the market

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reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities having a value exceeding 40 percent of its total assets. Section 3(c)(1) of the Investment Company Act excludes from the definition of "investment company" a fund that has not more than 100 beneficial owners and does not publicly offer its securities. Section 3(c)(7) of the Investment Company Act excludes from the definition of "investment company" a fund that is owned only by "qualified purchasers" and does not publicly offer its securities. Sections 3(c)(1) and 3(c)(7) are the two exclusions relied upon by private investment funds to avoid investment company status in the United States.

[8] An offshore fund that has no U.S. investors does not have to rely on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act to avoid investment company status and therefore is not a "private fund". Query whether even an offshore fund with U.S. investors needs to rely on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act if it does not market itself in the United States to U.S. investors.

[9] Advisers Act §203(b)(3), 15 U.S.C. §80b-3(b)(3) (prior to amendment by Dodd-Frank).

[10] Advisers Act Rule 203(b)(3)-1(a)(2)(i). In 2004 the SEC tried to change this rule and treat the investors in a fund as the adviser's clients for purposes of determining whether the adviser had 15 or more clients. In *Goldstein v. Securities and Exchange Commission,* 451 F.3d 873 (D.C. Cir. 2006), the court invalidated that rule.

[11] In contrast, having fifteen or more clients does not by itself trigger a federal registration requirement for U.S.-based advisers that are doing business in a state that regulates investment advisers. Those U.S. advisers also have to meet certain minimum asset thresholds before they are first eligible, and then required, to register with the SEC. U.S.-based advisers falling in this category are currently not eligible to register with the SEC if they have less than $25 million under management. Jurisdiction over these smaller advisers is relegated exclusively to the states. U.S. advisers with at least $25 million under management but less than $30 million can register with the SEC under current rules but are not required to. Only when a U.S. adviser has both fifteen or more clients and $30 million or more under management is it required under current law to register with the SEC. Advisers Act §203A(a)(1), 15 U.S.C. §80b-3A(a)(1) (prior to amendment by Dodd-Frank); and Advisers Act Rule 203A-1.

for alternative investment products became more institutionalized and competition for investors intensified, the pressure to register increased and many fund advisers voluntarily registered with the SEC. However, because the Advisers Act has historically focused on the operations of the adviser, and not the funds it managed, registration of a fund's adviser did little to address the post-financial crisis concerns of policymakers and regulators over the lack of transparency they had into the investment activities and trading operations of the funds themselves. The Act addresses these perceived shortcomings both by requiring the registration of those advisers considered by Congress to pose the greatest potential systemic risk and compelling registered and certain unregistered advisers with private fund clients to maintain and provide to the SEC specific information about the funds they manage.

Between now and the effective date for compliance with the Act, every non-U.S. adviser should be determining whether it is subject to the Act and, if so, whether it will be required to register as an investment adviser with the SEC or comply with the record maintenance and information reporting obligations imposed by the Act.

Applicability of the Act to Non-U.S. Advisers

The Act eliminates the blanket private adviser registration exemption currently available to advisers having fewer than fifteen clients during the preceding twelve months and replaces it with a narrower exemption available only to "foreign private advisers." A "foreign private adviser" is an adviser with no place of business in the United States that, among other things, has fewer than fifteen clients and investors in the United States in private funds that it advises and aggregate assets under management attributable to such clients and investors of less than $25 million.[12] The Act also creates new exemptions for, among others, advisers to "private funds" and "venture capital funds."[13]

Considerable attention has understandably been given to these new exemptions from registration, and each of them is discussed below. However, an interesting threshold question of practical importance to non-U.S. advisers is whether Congress, in replacing the private adviser exemption with a new registration exemption available only to non-U.S. advisers, intended to extend the reach of the Advisers Act and require all non-U.S. advisers who do not qualify for the new exemption to register with the SEC. Stated differently, does failure to qualify for an exemption from registration necessarily create a registration obligation for a non-U.S. adviser with no U.S. clients and no place of business in the United States?

The Issue of Extraterritoriality

The Advisers Act makes it unlawful for any investment adviser, unless registered with the SEC, to make use of the U.S. mails or any means or instrumentality of interstate commerce in

[12] Dodd-Frank, Pub. L. No.111-203, 124 Stat. 1367, §403(2), amending Advisers Act §203(b)(3).

[13] The Act also provides a registration exemption for advisers to private funds who are registered with the Commodity Futures Trading Commission as commodity trading advisers so long as they do not provide predominantly securities-related advice to such private funds, and imposes increased assets under management thresholds for federal registration applicable to U.S. advisers who are doing business in states that regulate and examine advisers. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1367, §§403(4) and 410(2), amending Advisers Act §§203(b)(6) and 203A(a)(1).

connection with its business as an investment adviser.[14] The Act does not change this fundamental jurisdictional requirement for application of the Advisers Act, and that requirement is the reason why a non-U.S. adviser with no U.S. clients who does not hold itself out to the public in the United States as an investment adviser is not subject to the Advisers Act.

Some have suggested that, by replacing the private adviser exemption with the foreign private adviser exemption, the Act creates a potential registration obligation for a non-U.S adviser that has no U.S. clients. Under this view, a non-U.S. adviser whose only clients are offshore funds and other non-U.S. persons would be required to register if its offshore fund clients had fifteen or more U.S. investors or $25 million or more of assets attributable to U.S. investors. Such an interpretation of the Act would constitute a breathtaking expansion of the territorial reach of the Advisers Act that is not supported by the Act or its legislative history. Given the strong presumption against the extraterritorial application of U.S. laws recently confirmed by the Supreme Court in *Morrison v. National Australia Bank Ltd.*,[15] the absence of an express indication by Congress of an affirmative intent to achieve this result necessitates the rejection of this position.

The *Morrison* case arose out of the acquisition by National Australia Bank Ltd., an Australian bank whose shares are traded on the Australian Stock Exchange, of HomeSide Lending, Inc., a Florida-based mortgage servicing company. Not long after the bank's acquisition of HomeSide, the bank wrote-down the value of HomeSide by over $2 billion, causing a sharp decline in the price of its shares. Australian shareholders of the bank sued the bank, HomeSide and executives of each company in the United States alleging that they manipulated the valuation of HomeSide prior to the write-down in violation of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder. The issue before the Court was whether Section 10(b) applies extraterritorially and provides a cause of action to foreign plaintiffs suing foreign and American defendants for misconduct in connection with the securities of a foreign company traded on a foreign exchange. Finding no affirmative indication in the Exchange Act that Section 10(b) applied extraterritorially, the Supreme Court concluded that it does not.[16]

The *Morrison* case establishes the standard to be used to determine if a statute applies extraterritorially. The lower court applied the well-established "conduct" and "effects" test, which looks to whether the wrongful conduct occurred in the United States or had a substantial effect in the United States or upon United States citizens, to determine whether it would be

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[14] Advisers Act §203(a). It is well-settled that a non-U.S. adviser with no U.S. clients can use the mails and other means or instrumentalities of interstate commerce to invest client funds in the U.S. and effect securities transactions through U.S. brokers without becoming subject to the Advisers Act. See *Seow Gim-Seong*, SEC No-Action Letter (Nov. 30, 1987); *BOH Investment Management Co.*, SEC No-Action Letter (Jan. 2, 1987). Offering securities issued by an offshore private fund to U.S. persons in a private placement alone is not an investment advisory business. *See e.g.* Proposed Advisers Act Rule 202(a)(30)-1(b)(2) ("an 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 owners as a group solely with respect to the performance of or plans for the legal organization's assets or similar matters.") The offering of securities in the United States is governed by the Securities Act of 1933, not the Advisers Act.

[15] 130 S.Ct. 2869 (2010).

[16] *Id.* at 2883.

reasonable to apply the statute extraterritorially. Under this test, if the reviewing court concludes that application of the statute is reasonable, then Congressional intent to apply the law extraterritorially is presumed. The Supreme Court rejected this as a "judicial-speculation-made-law" approach to "divining what Congress would have wanted if it had thought of the situation."[17] Instead, the analytical framework adopted by the Court in *Morrison* starts with a strong presumption against extraterritoriality and requires the clear expression by Congress of an affirmative intention to give the statute extraterritorial effect to overcome that presumption.[18]

The Court's analysis of the Exchange Act in *Morrison* is instructive because many of the characteristics of the Exchange Act that the Court found not to support its extraterritorial application are present in the Act.

Like the Advisers Act, the Exchange Act bases jurisdiction on the use of the U.S. mails or other means or instrumentalities of interstate commerce. The petitioners and the United States argued in *Morrison* that because interstate commerce includes commerce between the states and foreign countries, this was a sufficient indication of Congressional intent to apply the statute extraterritorially. The Court disagreed. "[W]e have repeatedly held that even statutes that contain broad language in their definitions of commerce that expressly refer to foreign commerce do not apply abroad. . . . The general reference to foreign commerce in the definition of interstate commerce does not defeat the presumption against extraterritoriality."[19]

The petitioners and the United States next argued that a Congressional observation that prices for securities traded on U.S. exchanges and over-the-counter markets are disseminated and quoted throughout foreign countries, made when describing the purpose of the Exchange Act, was sufficient evidence of Congress' intent that the Exchange Act have extraterritorial application. Again, the Court disagreed. "The fleeting reference to the dissemination and quotation abroad of the prices of securities traded in domestic exchanges and markets cannot overcome the presumption against extraterritoriality."[20]

In contrast to the observation made by Congress regarding the Exchange Act, there is nothing in the sparse legislative history of the Act, let alone a fleeting observation, suggesting that Congress actually intended, in adopting the new foreign private adviser exemption from registration, to expand the extraterritorial reach of the Advisers Act to cover non-U.S. advisers with no U.S. clients who, because of either the number of U.S. investors in the offshore private

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[17] *Id.* at 2878-81.

[18] As stated by the Court:

> "It is a long standing principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States. . . . Thus, unless there is the affirmative intention of the Congress clearly expressed to give a statute extraterritorial effect, we must presume it is primarily concerned with domestic conditions. . . . When a statute gives no clear indication of an extraterritorial application, it has none." *Id.* at 2877-78 (citations and internal quotation marks omitted).

[19] *Id.* at 2882 (footnotes and citations omitted).

[20] *Id.*

funds they manage or the amount of assets invested in those funds by U.S. investors, do not fall within the definition of a foreign private adviser.

The final argument advanced in *Morrison* was that another section of the Exchange Act, §30(b), contemplates the extraterritorial application of the Exchange Act by providing an exemption from its provisions for certain conduct that occurs outside the United States.[21] The United States argued that this exemption "would have no function if the [Exchange] Act did not apply in the first instance to securities transactions that occur abroad."[22] The Court was not convinced. "[I]t would be odd," noted the Court, "for Congress to indicate the extraterritorial application of the whole Exchange Act by means of a provision imposing a condition precedent to its application abroad."[23]

It would be equally odd to conclude that Congress indicated an intent to apply the Advisers Act extraterritorially by providing an exemption from registration to foreign private advisers.

So what does this mean for a non-U.S. adviser with no place of business in the United States who advises only offshore funds and other non-U.S. clients but, because of the number of U.S. investors in its offshore funds or the amount of assets they have invested, does not qualify for any of the new registration exemptions discussed below? Does its failure to qualify for a registration exemption create an affirmative obligation to register under the Act? The answer should be no.

Under existing law, which is not changed by the Act, offshore private funds, and not their investors, are the adviser's "clients" for purposes of the Advisers Act.[24] The Act actually reinforces this principle in other contexts by expressly prohibiting the SEC from defining the term "client," for purposes of applying the anti-fraud provisions of the Advisers Act, to include an investor in a private fund. A non-U.S. adviser whose only clients are offshore funds and other non-U.S. persons therefore has no U.S. clients (even if U.S. persons are invested in the offshore funds) and, if it is not otherwise conducting business in the U.S., remains outside the jurisdictional reach of the Advisers Act and should not need to register. If Congress intended that non-U.S. advisers register under the Advisers Act if the offshore funds they advise have U.S. investors, either the term "client" had to be redefined to include investors in private funds or an independent registration obligation had to be created for advisers to offshore private funds having the requisite level of U.S. participation. The Act does not do this, and absent the

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[21] The provision cited was Section 30(b) of the Exchange Act, 15 U.S.C. §78a, which reads as follows:

> "The provisions of the [Exchange Act] or of any rules or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate to prevent the evasion of [the Exchange Act.]"

[22] 130 S.Ct. 2869, 2882.

[23] *Id.*

[24] This fundamental principle was confirmed in *Goldstein v. Securities and Exchange Commission*, 451 F.3d 873 (D.C. Cir. 2006).

affirmative intention of Congress clearly expressed to give the Act such extraterritorial application, as required by *Morrison*, the Act should not apply to such an adviser.

This conclusion is also the most reasonable result when the new foreign private adviser registration exemption is considered in the context of the amendments made by the Act and the established jurisdictional framework of the Advisers Act. If Congress had simply repealed the current private adviser registration exemption, the effect would have been that a non-U.S. adviser with a single U.S. client would be subject to SEC registration without regard to the amount of assets it managed for that client. But the Act did not simply repeal the private adviser exemption, it replaced it with a new exemption available only to foreign private advisers. Instead of interpreting that exemption as expanding the territorial reach of the Advisers Act to capture non-U.S. advisers with no U.S. clients who fail to satisfy the conditions of the new exemption because of the number of U.S investors in their offshore funds or the amount of assets invested by such persons, the more defensible statutory construction is to view the exemption as an acknowledgment that even a non-U.S. adviser with a U.S. client may lack sufficient nexus with the U.S. to support subjecting it to regulation under the Advisers Act. The Act therefore permits a non-U.S. adviser with a U.S. client, who would have been subject to SEC registration after repeal of the blanket private adviser exemption, to avoid having to register with the SEC if it qualifies as a foreign private adviser. The Act cannot properly be viewed as creating, through the back door of the new foreign private adviser exemption, a registration requirement for a non-U.S. adviser with no U.S. clients where none previously existed.[25] One would hope that the SEC will provide confirmation of this point when it issues its final regulations under the Act.

Let us now examine the exemptions from registration that are available to a non-U.S. adviser to private funds that is subject to the Advisers Act, starting with the foreign private adviser exemption summarized above.

Foreign Private Adviser Exemption

"Foreign private advisers" will be exempt from registration under the Act. A "foreign private adviser" is an adviser who has no place of business in the United States,[26] does not hold itself out generally to the public in the United States as an investment adviser, does not advise a registered investment company or a business development company, and has in total "fewer than *fifteen clients and investors in the United States* in private funds" that it advises and aggregate assets under management "attributable to *clients in the United States and investors in the United*

[25] For a non-U.S. adviser that has a U.S. advisory affiliate conducting advisory activities in the United States, additional considerations come into play in determining whether it is subject to the Advisers Act. If the two entities are not treated separately, the activities of the U.S. affiliate will bring the non-U.S. adviser into the U.S. and subject it to the Advisers Act.

In a series of no-action letters, the SEC has identified the operational and other requirements necessary for a non-U.S. adviser to be treated separately from its U.S. advisory affiliate. See *Uniao de Bancos de Brasileiros S.A.*, SEC No-Action Letter (July 28, 1992), and *Richard Ellis*, SEC No-Action Letter (September 17, 1981).

[26] A place of business is defined in proposed Advisers Act Rule 203(a)(30)-1 as any office where the 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.

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States in private funds" that it advises of less than $25 million (or such higher amount as the SEC may by rule prescribe).[27]

A careful reader will notice that, in defining an exempt foreign private adviser, the part of the test that counts clients is phrased differently than the part that measures assets under management. To qualify as a "foreign private adviser," the adviser must have in total "fewer than *15 clients* and investors in the United States in private funds" that it advises and aggregate assets under management "attributable to *clients in the United States* and *investors in the United States* in private funds" that it advises. (Emphasis added). Because the fifteen client part of the test is not qualified by the phrase "in the United States," some speculated whether Congress intended that a foreign adviser count all its clients, not just those in the United States, when determining whether it qualified as a foreign private adviser. In the release accompanying the proposed rules issued late last year, the SEC stated that it interprets these provisions consistently so that only clients in the United States and investors in the United States should be counted.[28] For these purposes, a client or investor in the United States means any person that is a "U.S. person" as defined in Regulation S,[29] except that a 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 and, therefore, is not a U.S. person under Regulation S, will be treated as a U.S. person for these purposes if the dealer or professional fiduciary is related to the adviser relying on the exemption. A person who becomes a U.S. person may be treated as not being in the United States if such person was not a U.S. person at the time of becoming a client, or, in the case of an investor in a private fund, at the time the investor acquires the fund's securities.[30]

Two major differences between the new foreign private adviser exemption and the broader private adviser exemption it replaces are readily apparent.

First, availability of the foreign private adviser exemption depends not just on the number of U.S. clients the adviser has, but on the total number of U.S. clients plus U.S. investors in private funds managed by the adviser. Investors in private funds, of course, are not clients of the adviser and previously were not taken into account in determining eligibility for the private adviser exemption.[31] Second, the foreign private adviser exemption introduces a separate assets

[27] Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376, §402(a), adding new Section 203(b)(3) to the Advisers Act.

[28] SEC Release No. IA-3111, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers, p. 72, footnote 225 (November 19, 2010). *See also*, SEC Release No. IA-3110 (November 19, 2010), Rules Implementing Amendments to the Investment Advisers Act of 1940.

[29] Regulation S, Securities Act Rule 901, 17 C.F.R. §230. The term "U.S. Person" is defined in paragraph (k) of Rule 902 and includes a natural person resident in the U.S., a partnership or corporation organized or incorporated under the laws of the U.S., a U.S. agency or branch of a foreign entity, an estate or trust of which the executor, administrator or trustee is a U.S. person, non-discretionary accounts held by a dealer or other fiduciary for the benefit or account of a U.S. person, discretionary accounts held by a dealer or other fiduciary organized, incorporated or resident in the U.S., and certain foreign partnerships or corporations formed by U.S. persons principally for the purpose of investing in unregistered securities.

[30] SEC Release No. IA-3111, p. 82 (November 19, 2010).

[31] Looking through a private fund to its investors to determine a non-U.S. adviser's eligibility for the foreign private adviser exemption is counter to the principle established in *Goldstein v. Securities and Exchange Commission, supra*, note 24, and is inconsistent with the way the Act treats U.S. advisers.

under management test that previously did not exist, and this test counts assets attributable to both U.S. clients of the adviser and U.S. investors in private funds managed by the adviser. As illustrated in the following examples, these changes depart significantly from current law.

> **Example 1.** Non-U.S. adviser ABC Co. has no U.S. clients but manages multiple offshore funds which have in total 14 U.S. investors who have invested in the aggregate $10 million. The funds are performing well and a U.S. person wanting exposure to the strategy retains ABC Co. to manage a $1 million account it opens with Merrill Lynch in London. In accepting this managed account client, ABC Co. now has one U.S. client; however, it is not an exempt foreign private adviser because when that client is added to the number of U.S. investors in the offshore funds managed by ABC Co., the total is 15.

> **Example 2.** Assume the same facts as Example 1 except there are no U.S. investors in the offshore funds managed by ABC Co. and the U.S. person establishes the managed account with $25 million. Although ABC Co. has only one U.S. client and there are no U.S. investors in the funds it manages, ABC Co. is not an exempt foreign private adviser because it has assets under management attributable to its one U.S. client of at least $25 million.

A non-U.S. adviser seeking to qualify for exemption as a foreign private adviser must therefore have, in the aggregate, less than 15 U.S. clients and U.S. investors in the private funds that it advises, and assets under management attributable to those U.S. clients and U.S. investors of less than $25 million. Stated conversely, a non-U.S. adviser will not be an exempt foreign private adviser if (1) it has, in the aggregate, fifteen or more U.S. clients and U.S. investors in the private funds its advises, regardless of the amount of assets it manages for its U.S. clients and U.S. investors, or (2) it has fewer than fifteen U.S. clients and U.S. investors in the private funds it advises, but manages at least $25 million for those clients and investors.

The foreign private adviser exemption does not contain the 12-month rolling look-back concept previously embodied in Section 203(b)(3), but instead looks at a snapshot of the number of U.S. clients and investors and the amount of their assets under management at any moment in time. That means a non-U.S. adviser is eligible for the exemption even if, during the preceding twelve months, it had in total 15 or more different U.S. clients or U.S. investors in the private funds it manages, or in aggregate $25 million or more in assets attributable to such clients and investors, as long as it did not have 15 or more U.S. clients or U.S. investors or $25 million or more in assets attributable to them at any one time.

In a change from current law, the adviser must count all U.S. clients and investors, even if the adviser does not receive any compensation from those clients or investors.[32] The adviser can treat as a single client for these purposes an entity to which the adviser provides investment advice based on the entity's investment objectives, and two or more entities that have identical shareholders, partners, members or beneficiaries. To avoid double counting private funds and their investors, the SEC has proposed rules that allow an adviser not to count a private fund as a client if the adviser counted any investor in that private fund as an investor for purposes of determining the availability of the exemption, and to count as a single investor a person who is

[32] *Id.* p. 73.

an investor in two or more private funds.[33] However, the adviser must count as an investor for these purposes the holder of any instrument, such as a total return swap, that effectively transfers to such person the risk of investing in the private fund from the record owner of the private fund's securities.[34]

Private Fund Adviser Exemption

The Act creates a new exemption from registration for any adviser who acts solely as an adviser to private funds and has assets under management in the United States of less than $150 million.[35] By its terms this exemption is available to any adviser, whether U.S. or non-U.S., that acts solely as an adviser to private funds. In the case of a non-U.S. adviser, the SEC has proposed that the exemption be available as long as the adviser's only U.S. clients are private funds. A non-U.S. adviser can therefore have non-private fund clients outside the United States and still be eligible for this exemption.[36]

To qualify for the private fund adviser exemption the adviser must have "assets under management in the United States" of less than $150 million. The SEC has proposed a definition of "assets under management in the United States" that greatly expands the scope of the private fund adviser exemption for non-U.S. advisers. Under proposed Rule 203(m)-1(b), for a non-U.S. adviser whose principal place of business is outside the U.S., private fund assets under management in the United States include only assets it manages from a place of business in the United States.[37] By this definition, a non-U.S. adviser with no place of business in the U.S. cannot have any assets under management in the United States. Such an adviser can therefore manage an unlimited number of offshore and U.S. private funds without having to register in the U.S., regardless of the amount of assets in those private funds, as long as the adviser does not have any U.S. clients other than private funds.[38]

This extremely broad relief from registration is not the panacea it may at first appear to be. A non-U.S. adviser relying on the private fund adviser exemption to avoid registration will nonetheless be an "exempt reporting adviser" and therefore required to maintain certain records, which the SEC has the authority to examine, and submit to the SEC and periodically update

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[33] In a master-feeder fund structure, the adviser to the master fund would have to treat as investors the holders of the securities of the feeder funds, rather than the feeder funds themselves. *Id.* p. 78-79.

[34] SEC Release No. IA-3111, p. 79 (November 19, 2010).

[35] Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376 §408, adding Section 203(m) to the Advisers Act.

[36] Proposed Advisers Act Rule 203(m)-1(b).

[37] Proposed Advisers Act Rule 203(m)-1(b). *See* note 26 *supra* for what constitutes a "place of business" in the U.S. All of the assets managed by an adviser would be deemed to be managed in the U.S. if the adviser's principal office and place of business were in the U.S.

[38] The SEC has solicited comments on whether it should instead interpret "assets under management in the United States" by reference to the source of the assets rather than the place from where they are managed. The proposed rules also do not address, and the SEC has solicited comments on, how to count assets that are managed by teams or affiliates located in multiple jurisdictions. SEC Release No. IA-3111, pp. 64-69 (November 19, 2010). The interaction between the private fund adviser exemption, the foreign private adviser exemption, and the jurisdictional limitations of the Advisers Act discussed above raise many interesting issues, beyond the scope of this article, that call out for clarification by the SEC.

certain information using Form ADV, Part I. These reporting obligations are described later in this article.

Venture Capital Fund Adviser Exemption

Advisers whose only clients are "venture capital funds" also are exempt from registration under the Act. To qualify for this exemption, all of the clients of the non-U.S. adviser, not just its U.S. clients, must be venture capital funds. Unlike the private fund adviser exemption discussed above, this exemption is available without regard to the amount of assets the adviser manages for its venture capital fund clients. For a private fund adviser with no place of business in the United States, this difference is of no practical consequence. Because such an adviser has no assets under management in the United States, the $150 million asset cap under the private fund adviser exemption is of no consequence to it, so whether it is advising U.S. hedge funds, private equity funds or venture capital funds makes no difference. It is exempt from registration in any event. However, if the adviser manages venture capital funds from a place of business in the United States that is not its principal office, then this exemption allows it to do so without registration even if the aggregate assets of such funds exceeds $150 million.

The proposed rules define a venture capital fund as a private fund that (i) invests in equity securities of "qualifying portfolio companies"[39] in order to provide operating and business expansion capital, and at least 80 percent of each qualifying portfolio company's securities owned by the fund were acquired directly from the qualifying portfolio company; (ii) directly, or through its advisers, offers or provides significant managerial assistance to, or controls, the qualifying portfolio company; (iii) does not borrow or otherwise incur leverage in excess of fifteen percent of its aggregate capital contributions and uncalled capital commitments and all such leverage is for a non-renewable term of 120 days or less; (iv) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (v) represents itself as a venture capital fund to investors; (vi) is not registered under the Investment Company Act and has not elected to be treated as a business development company; and (vii) holds only cash and cash equivalents, U.S. Treasury securities with a remaining maturity of 60 days or less, and equity securities of qualifying portfolio companies.[40]

Like an adviser relying on the private fund adviser exemption, an adviser relying on this exemption will nonetheless be an "exempt reporting adviser" subject to record maintenance and reporting obligations.

Recordkeeping and Reporting Obligations

An important objective of regulatory reform was to provide government regulators the tools they need to gather from financial industry participants sufficient information to monitor

[39] A qualifying portfolio company is a company that (i) is not publicly traded or affiliated with a publicly traded company, (ii) does not incur leverage in connection with the investment made by the venture capital fund, (iii) uses the capital invested by the venture capital fund for operating or business expansion purposes, and (iv) is not itself a private fund or other pooled investment vehicle (*i.e.*, is an operating company). Proposed Advisers Act Rule 203(l)-1(c)(4).

[40] Proposed Advisers Act Rule 203(l)-1. Provision is made to grandfather existing venture capital funds that satisfy certain criteria under proposed Advisers Act Rule 203(l)-1(b).

and assess systemic risk. To that end, the Act imposes new recordkeeping and reporting obligations on advisers to private funds.

The Act requires registered advisers to maintain such records of, and file with the SEC such reports regarding, the private funds they advise as "necessary and appropriate" in the public interest and for the protection of investors or the assessment of systemic risk. The records of a private fund that is advised by a registered adviser are deemed to be the records of the adviser and thus are subject to inspection by the SEC. The records and reports required to be maintained by a registered adviser and subject to inspection by the SEC shall include, for each private fund advised by the adviser, a description of:

(1) the amount of assets under management and the use of leverage, including off-balance sheet leverage;

(2) counterparty credit risk exposure;

(3) trading and investment positions;

(4) trading practices;

(5) valuation policies and practices of the fund;

(6) types of assets held;

(7) side arrangements or side letters, whereby certain investors obtain more favorable rights or entitlements than others; and

(8) such other information as the SEC, in consultation with the Financial Stability Oversight Council[41], determines "necessary and appropriate" in the public interest and for the protection of investors or for the assessment of systemic risk.[42]

The reports required by the Act will be submitted on a redesigned Form ADV, which will be filed electronically and will be publicly available on the SEC's website.[43]

The Act also requires that advisers exempt from registration by reason of the new private fund adviser or venture capital fund adviser exemptions maintain such records and submit such reports as the SEC determines necessary or appropriate in the public interest.[44] In its proposed rules the SEC refers to these advisers as "exempt reporting advisers."[45]

[41] The Financial Stability Oversight Council was established by Dodd-Frank and is charged with identifying threats to the financial stability of the United States, promoting market discipline, and responding to emerging risks to the stability of the U.S. financial system.

[42] Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376, §404, adding Advisers Act Section 204(b).

[43] Form ADV currently is used only to apply for registration as an adviser. The form is being redesigned so it can be used both for registration and reporting purposes.

[44] Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376, §§407 and 408, adding Advisers Act §§203(l) and 203(m).

[45] Proposed Advisers Act Rule 204-4; SEC Release No. IA-3110, p. 176 (Nov. 10, 2010).

Exempt reporting advisers will be required to submit, and to periodically update, reports to the SEC by completing a limited subset of items on the redesigned Form ADV. An exempt reporting adviser's Form ADV will be filed electronically and will be publicly available on the SEC's website. The information to be reported by exempt reporting advisers on Form ADV will include generally the following:

(1) identifying organizational and ownership information of the adviser;

(2) details regarding other business activities of the adviser (including acting as a commodity pool operator, commodity trading advisor, security-based swap dealer or major security-based swap participant);

(3) disciplinary histories of the adviser and its affiliates; and

(4) information regarding the private funds advised by the adviser (of the same type as required from registered advisers and described above). However, non-U.S. advisers will not have to report on offshore private funds that are not offered to, or owned by, U.S. persons.[46]

Registered advisers and exempt reporting advisers are required to amend their Form ADV at least annually within 90 days of the end of the adviser's fiscal year, and promptly if the responses to certain items become inaccurate. The initial report of an exempt reporting adviser on Form ADV is required to be filed no later than August 20, 2011, although this deadline will likely be pushed back if the compliance date for the Act is delayed until the first quarter of 2012, as suggested by senior SEC officials.[47]

Amendments to "Pay to Play" Rule

Advisers Act Rule 206(4)-5 prohibits any investment adviser registered (or required to be registered) with the SEC, and certain advisers exempt from registration, from providing investment advisory services for compensation to a government entity within two years after the adviser or a covered associate of the adviser has made a contribution to an official of the government entity. The rule also makes it unlawful for an adviser and its covered associates to pay any third party to solicit a government entity for investment advisory services unless such third party is a regulated person.[48] For these purposes, an adviser to a private fund in which a governmental entity invests or is solicited to invest is treated as providing or soliciting to provide investment advisory services directly to the government entity. These rules generally became effective on March 14, 2011, and compliance with the rule relating to payments to third party solicitors will be required by September 13, 2011.

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[46] SEC Release No. IA-3110, p. 50 (Nov. 10, 2010).

[47] See footnote 5, *supra*.

[48] A "regulated person" is defined as a registered investment adviser or a broker-dealer subject to the rules of a registered national securities association.

The SEC has proposed amendments to Advisers Act Rule 206(4)-5 that would make it apply to exempt reporting advisers and foreign private advisers.[49]

What Does it All Mean?

The devil is, as they say, in the details, and many important details will remain uncertain until final implementing regulations are published by the SEC. The Act also mandates three studies, including one by the General Accounting Office regarding the feasibility of forming a self-regulatory organization to oversee private funds, that could provide the basis for further legislative and regulatory action affecting private funds and their advisers. Clearly, the next few years will be a period of continuing change.

On the threshold issue of the extraterritorial application of the Advisers Act, a non-U.S. adviser with no place of business in the United States and no U.S. clients who does not satisfy the criteria for exemption as a foreign private adviser should still not be subject to the Act. An adviser to a private fund treats the fund, and not its investors, as its client, and a non-U.S. adviser to offshore funds and other non-U.S. persons should remain outside the reach of the Act even if its offshore fund clients have U.S. investors, or assets attributable to them, in excess of the amounts permitted under the foreign private adviser exemption. However, as of this writing it is not clear whether the SEC will adopt this view.

Non-U.S. advisers who are determined to be subject to the Act will now have to register with the SEC unless they qualify for an exemption. The most likely exemptions are the foreign private adviser, private fund adviser and venture capital fund adviser exemptions discussed above.

A non-U.S. a adviser relying on the foreign private adviser registration exemption will also be exempt from the record maintenance and reporting obligations imposed by the Act. However, non-U.S. advisers relying on the private fund adviser or venture capital fund adviser registration exemptions are "exempt reporting advisers" under the Act and will have to maintain specified records for inspection by, and submit specified information to, the SEC, as discussed above. Exempt foreign private advisers, private fund advisers and venture capital fund advisers all will be subject to the SEC's pay-to-play rules as of the effective date of the Act.

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[49] Proposed Advisers Act Rule 206(4)-5(a); SEC Release No. IA-3110, p. 68 (Nov. 10, 2010). The SEC has also proposed to amend the rule to require that third parties paid to solicit government entities be "regulated municipal advisors."