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# Client Alert

A report
for clients
and friends
of the Firm

April 2007

# Regulation of Non-U.S. Investment Advisors and Portfolio Managers Doing Business in the United States

A number of non-U.S. investment counseling firms and investment dealer firms have inquired about providing discretionary portfolio management and other investment advisory services to clients residing in the United States. This memorandum discusses the U.S. securities regulatory issues arising from the provision of such services in the United States:[1]

## I. Jurisdiction and Exemptions From Federal and State Registration

Section 203(a) of the U.S. Investment Advisers Act of 1940 (the "Advisers Act") prohibits an investment adviser[2] from making use of the mails or any means or instrumentality of interstate commerce in connection with its business as an investment adviser unless the adviser is registered under the Advisers Act.

Section 203(b) of the Advisers Act exempts from registration any investment adviser who, during the course of the preceding twelve months, has had fewer than fifteen clients, and who neither holds itself out to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act of 1940 (the "Investment Company Act") or a business development company pursuant to the Investment Company Act. The exemption enables non-U.S. firms to provide portfolio management services in the United States provided that they (i) do not actively promote their services in the United States and (ii) have fewer than fifteen U.S. clients during a rolling twelve-month period, even if they have substantially more clients worldwide. (*See Holburn, Beaudin & Lang*, SEC No-Action Letter (Aug. 13, 1984)).

If the foregoing exemption is available, Section 222(d) of the Advisers Act, added as a result of the National Securities Markets Improvement Act of 1996 ("NSMIA"), also exempts the firm from state registration, provided that during the same 12-month period it had fewer than 6 clients who are residents of any particular state. The states, however, retain investigatory and enforcement jurisdiction with respect to exempt advisers.

No filings are required to be made to rely on the foregoing exemptions.

## II. Investment Adviser Registration

If the foregoing exemptions are too limited, the non-U.S. adviser or a specially created entity affiliated with the adviser likely would have to register as an investment advisor with the U.S. Securities and Exchange Commission ("SEC") or with the individual states.

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1 This memorandum does not discuss certain related topics which may be relevant in specific cases, including (i) broker-dealer registration and compliance issues, which will be addressed in a subsequent memorandum, (ii) the specialized rules applicable to the management of pension fund assets, (iii) use of derivatives in portfolio management and (iv) rules applicable to collective investment vehicles such as mutual funds or pooled funds. We would be pleased to provide guidance in these areas on request.

2 Section 202(a)(11) of the Advisers Act defines the term "investment adviser" generally to mean:

> 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.

The definition goes on to exclude banks, broker-dealers, attorneys, accountants and other identified persons who provide investment advice incidental to other professional services.

## A. Federal or State Registration

Under NSMIA, the regulation of investment advisers is divided between the SEC and the states. In general, if an adviser manages more than U.S. $25 million in assets it must register with the SEC, but not with the states.[3] In order to register with the SEC as an investment adviser, an applicant must complete and file with the SEC the Uniform Application for Investment Adviser Registration on Form ADV Part I. Since January 2001, Form ADV must be filed electronically through the Investment Advisers Registration Depository ("IARD"), which is administered by the National Association of Securities Dealers, Inc. ("NASD") and the appropriate filing fees must be paid to the NASD.[4] The IARD is available at http://www.iard.com.

Form ADV consists of two parts and Schedules A through I (to be completed as necessary). Part I requires administrative information, including (i) the adviser's name, state of organization, and the locations of its principal place of business and offices (ii) ownership structure and controlling persons, (iii) financial and operational information, (iv) state registrations, (v) discretionary and non-discretionary assets, (vi) whether the adviser maintains custody of clients' assets, (vii) disciplinary history and (viii) background information concerning personnel.[5] Part II requires information that must be provided to clients, including (i) the types of advisory services offered, (ii) whether such services constitute "financial planning," (iii) fees charged, (iv) affiliations with other securities professionals, (v) whether the adviser has investment discretion, and (vii) the adviser's education and professional background. Pursuant to Rule 203-1(b)(2) under the Advisers Act, an investment adviser does not have to file a copy of Part II of the Form ADV with the SEC. It must simply complete and maintain a current copy of Form ADV Part II (and any brochure distributed to clients in lieu of Part II) in its files. The completed Form ADV Part II or a brochure containing all the information required by Part II is required to be provided to a prospective client 48 hours prior to entering into an advisory agreement with the client.

Pursuant to Rule 0-2 under the Advisers' Act, a non-resident applicant is required to consent to service of process. Rule 204-2(j) under the Advisers' Act requires a non-resident applicant to file a notice with its Form ADV stating an address within United States where its books and records are maintained. However, pursuant to Rule 204-2(j)(3)(i), this is not required if the adviser files an undertaking with the SEC to provide, at its own expense, accurate copies of all books and records at the SEC's Washington, D.C. office or any regional office designated by the SEC. Upon the SEC's request, the non-resident applicant must provide the prescribed books and records to the SEC within 14 days.

The SEC must take action to grant or deny registration as an investment adviser within 45 days after filing Form ADV. The SEC may request additional information, which would commence a new 45-day review period. Once granted, a registration will cover the adviser's employees and other persons under its control provided that their advisory activities are done on behalf of the registered adviser. Thus, employees do not have to register individually with the SEC; and, if the registered advisor does not have any office in the United States, such

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[3] Certain states may require that the adviser make a "notice filing" with the state if the adviser has more than a specified number of clients within the state. The "notice filing" normally consists of filing (i) a Uniform Consent to Service of Process on Form U-2, (ii) a copy of the Form ADV as filed with the SEC and a filing fee (which can be between $70 to $300 depending on the state). Most filings are good for one year and are renewed in December each year.

[4] An applicant must set up an account at NASD to cover the registration fees. NASD will deduct the appropriate amount of fees from the account. The initial registration fee is paid upon the first electronic Form ADV filing and the annual updating fee is paid when the Annual Updating Amendment is filed.

The fees are as follows:

| Assets Under Management | Initial Set-up Fee | Annual Updating Fee |
|---|---|---|
| More than $100 million | $1,100 | $550 |
| $25 million to $100 million | $800 | $400 |
| Less than $25 million | $150 | $100 |

[5] More specifically, the form requires the disclosure of the following information pursuant to Section 203(C)(1) of the Advisers' Act:

(1) The name and form of business of the applicant;

(2) The name of the state or other sovereign power under which the applicant is organized;

(3) The location of the applicant's principal business office and branch office, if any;

(4) The names and addresses of the applicant's partners, officers, directors, and persons performing similar functions;

(5) The number of the applicant's employees;

(6) The education, the business affiliations for the past ten years, and the present business affiliations of the applicant and of its partners, officers, directors, and persons performing similar functions and of any controlling person thereof;

(7) The nature of the business of the applicant, including the manner of giving advice and rendering analyses or reports;

(8) A balance sheet certified by an independent public accountant and other financial statements;

(9) The nature and scope of the authority of the applicant with respect to clients' funds;

(10) The basis or bases upon which investment advice is compensated;

(11) Whether the applicant, or any person associated with the applicant, is subject to any disqualification which would be the basis for denial, suspension, or revocation of registration; and

(12) A statement as to whether the principal business of the applicant consists or is to consist of acting as investment adviser and a statement as to whether a substantial part of the business of the applicant consists or is to consist of rendering investment supervisory services.

persons do not have to pass any qualification examinations or have particular professional designations.

During the waiting period, the adviser should develop an Advisers Act compliance manual tailored to the Adviser's U.S. advisory business. This document should describe filing obligations, standards of conduct, substantive rules and supervisory responsibilities.

## B. Specific SEC Relief for Non-U.S. Advisors

The staff of the Division of Investment Management of the SEC (the "SEC Staff') granted special relief to non-U.S. investment advisors and financial services holding companies in a series of no-action letters that allows such companies to form and register affiliated companies to make use of the personnel and other resources of the unregistered company in providing discretionary advisory services and portfolio management services to U.S. clients.

The SEC had taken the position that registered investment advisers (whether domestic or foreign) are subject to the substantive provisions of the Advisers Act with respect to *all* of their clients - both U.S. and non-U.S. Consequently, foreign advisers were reluctant to register as investment advisers under the Advisors Act. However, the SEC Staff has made clear that a non-U.S. adviser may establish an affiliated company to register under the Advisers Act, thereby limiting the application of the Advisers Act to the registered affiliate and avoiding the need for registration and regulation of the corporate parent. The affiliate must have a separate and viable commercial existence.

In 1981, the SEC Staff established certain conditions to be met to demonstrate the degree of "separateness" required of U.S. registrants affiliated with non-registered, non-U.S. advisors in a "no-action letter" issued to Richard Ellis, Inc. (sometimes referred to as the "Ellis conditions").[6] Some of the Ellis conditions, particularly the condition requiring separate investment advisory personnel, posed significant practical difficulties.

In 1992, the SEC Staff announced a new policy that would apply the Advisers Act to non-U.S. advisers only when their activities take place in the United States or have a substantial effect in the United States or on U.S. persons.[7] The new approach was based on a "conduct and effects" test, whereby an adviser's activities would be regulated if it involved conduct in the United States or substantial and foreseeable effects in the United States. The SEC Staff also indicated that separate entities would be considered independently. The SEC Staff also recommended a relaxation of the Ellis conditions. Specifically, the SEC Staff proposed to drop the requirement for a separate board of directors, and agreed to permit personnel and communications to be shared with a subsidiary's corporate parent.

The SEC Staff specified that the new approach requires only that the subsidiary be staffed with qualified investment advisors. The subsidiary must supervise all personnel involved in advisory activities on behalf of U.S. persons (whether employed by the subsidiary or its parent), keep certain records relating to such personnel, and subject such personnel and their supervisors to the SEC's jurisdiction. The registrant must ensure that the SEC would have access to trading and other records at the corporate parent necessary to monitor and police conduct relevant to U.S. investors.

### 1. Relevant No-Action Letters

Since 1992, the SEC Staff has issued a series of no-action letters implementing the new policy and elaborating on the circumstances in which a registered investment adviser may make use of its unregistered affiliate's personnel, offices or other resources. The approach in these letters essentially follows the "conduct and effects" test.

#### a. Unibanco

The first in the series of no-action letters was Uniao de Bancos de Brasileiros S.A., July 28, 1992 ("*Unibanco*"). In *Unibanco*, the SEC Staff specifically permitted a registered investment adviser subsidiary to share advisory personnel with its unregistered parent, provided that the shared personnel were capable of advising clients and that the subsidiary was a separate legal entity. The SEC Staff's response included certain conditions to address its concern that the more relaxed approach would not lead to abuses such as placing trades of non-U.S. clients ahead of U.S. clients or entering into unauthorized agency cross transactions.

The most significant of these conditions requires that the unregistered parent company must agree that it will maintain and make available to the SEC for inspection certain books and records pertaining to "related securities transactions" of its registered investment adviser subsidiary. The parent company must also agree to make available to the SEC for testimony all persons engaged in the registered subsidiary's advisory operations (whether employed by the parent or the subsidiary). To ensure compliance with these undertakings, the parent

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6 These conditions required the subsidiary (i) to be separately and adequately capitalized; (ii) to have a majority of its board of directors independent of the parent company (or to have some similar "buffer" between it and the parent company); (iii) to have employees engaged in the day-to-day business of providing investment management advice who were not similarly engaged in the investment advisory business of the parent; (iv) to formulate its own advice to its clients using information sources in addition to those of its parent company; and (v) to keep its advice confidential until that advice is communicated to its clients.

7 Protecting Investors: A Half Century of Investment Company Regulation" (May 1992).

company must appoint an agent in the U.S. to accept service of administrative subpoenas for the production of documents and personnel. The parent company is not required to reveal the identity of its non-U.S. customers in connection with any such proceedings.

### b. National Mutual Group

National Mutual Group, March 8, 1993 ("*National Mutual*") dealt with non-U.S. companies that rendered advisory services to both U.S. and non-U.S. clients through the same entities. In *National Mutual*, the corporate structure consisted of the National Mutual Life Association of Australia ("National Mutual Life"), which, through certain holding companies, owned separate fund management companies in each of Europe, Japan, Asia and Australia (the "NMFM Companies"). Each of the NMFM Companies was subject to the regulations and licensing standards of its local jurisdiction. National Mutual Life also owned, through a non-U.S. holding company and two U.S. subsidiaries, CMB Investment Counselors ("CMB"), an investment adviser registered under the Advisers Act.

The NMFM Companies and CMB (together, the "National Mutual Life Group") wanted to provide investment advice directly to U.S. clients about their local markets by allocating assets among the NMFM Companies and CMB. In its response, the SEC Staff permitted the NMFM Companies to register under the Advisers Act, but did not require that they comply with most provisions of the Advisers Act pertaining to their relationships with their non-U.S. clients, subject to certain circumstances described in the letter.[8]

### c. Royal Bank of Canada

In Royal Bank of Canada, June 3, 1998 ("*Royal Bank*"), the proposed structure, like *Unibanco*, involved a separate subsidiary formed to advise U.S. clients that made use of personnel and resources of the non-U.S. parent corporation. The SEC Staff used the opportunity to reconsider certain undertakings previously articulated in *National Mutual* and *Murray Johnstone*, and noted that persons relying on these prior letters would also have to make clerical and ministerial personnel available for testimony or other questioning by the SEC or its staff upon receipt of an administrative subpoena, demand, or a request for voluntary cooperation made during a routine or special inspection.

The SEC Staff positions were based on certain representations and undertakings, which are described in detail in Appendix B, and must be disclosed on Form ADV Part II.

## 2. Reliance Upon Existing No-Action Letters

An SEC no-action letter is a statement by the SEC Staff that it would not recommend that the SEC take enforcement action if certain proposed activities took place. Officially, no-action letters are not binding on the SEC and have no value as a precedent. As a practical matter, however, no-action letters are important to industry participants and are relied on as quasi "safe harbors." A named recipient of a no-action letter stands in the best position with respect to the SEC, but a series of no-action letters can serve as informal precedent providing guidance to similarly situated parties to structure their business activities in accordance with the facts of the relevant no-action letters.

We have confirmed that a non-U.S. adviser may rely on the prior no-action letters described in this memorandum in structuring the business of an affiliate that itself registers as an investment adviser with the SEC, and that any such affiliate need not request its own no-action position from the SEC Staff. In fact, absent a unique set of facts which are wholly distinguishable from the various structures set forth in the existing no-action letters, the SEC Staff would not entertain a new request on the subject.

Of course, it is possible to register the non-U.S. operating company and to apply the Advisers Act only to U.S. accounts. However, in order to minimize the impact of the required undertakings, to limit the scope of SEC regulation and to limit liability arising from U.S. activities, it is normally advisable for the non-U.S. company to form a separate legal entity to register under the Advisers Act.

* * *

We would be pleased to assist you in structuring your activities in compliance with the Advisers Act, including registration as an investment adviser under the Advisers Act, reliance upon available exemptions and development of compliance procedures.

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[8] In 1994, the SEC Staff issued a similar, favorable response to a no-action request by Murray Johnstone International Limited, October 7, 1994 ("*Murray Johnstone*"). The SEC Staff essentially reaffirmed the approach taken in *National Mutual*, and restated the provisions of the Advisers Act that would not apply in connection with non-U.S. clients. These provisions are summarized in Appendix A.

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