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FALLOUT FROM THE DODD-FRANK ZONE: LESSONS AND CHALLENGES FOR INVESTMENT ADVISERS

The Dodd-Frank Act eliminated the "private adviser" exemption from registration under the Advisers Act and instead imposes registration requirements based on the amount of RAUM. The Act also included new exemptions for certain advisers to "private funds," and for certain foreign private advisers. Other changes relate to the extraterritorial reach of the antifraud laws, new custody rules, and whistleblowers. The author discusses these developments, urges advisers to carefully design compliance programs, and addresses some of the murkier issues.

By Jay G. Baris *

Even as the regulatory dust begins to settle, investment advisers continue to feel the fallout from the Dodd-Frank Act.[1] Dodd-Frank fundamentally changed the playing field, leaving investment advisers scrambling to understand if and how its new mandates apply to situations that seldom arose under the pre-Dodd-Frank regulatory regime.

OBLIGATION TO REGISTER AS AN INVESTMENT ADVISER

Section 408 of the Dodd-Frank Act eliminated the "private adviser" exemption from registration under the Investment Advisers Act of 1940, as amended (the Advisers Act). Generally, this exemption permitted advisers to avoid registration with the Securities and Exchange Commission (SEC) if they had fewer than 15 clients, did not hold themselves out to the public as investment advisers, and did not serve as an adviser to a registered investment company or business development company. For purposes of this exemption, one private fund, no matter how large, counted as one client.

The primary purpose of eliminating the private adviser exemption was to require certain advisers to "private funds" to register under the Advisers Act. The Dodd-Frank Act also reallocated the primary responsibility for oversight of certain investment advisers by delegating to the states the responsibility to oversee mid-sized advisers – that is, those that have between $25 million and $100 million in assets under management (subject to the buffers described below).

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

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Threshold Question

For advisers, Dodd-Frank changed the threshold question to determine whether they must register with the SEC from "whom do they advise?" to "how much do they advise?" In the post-Dodd-Frank world, the SEC measures "assets under management" and "regulatory assets under management" (RAUM), rather than the number of clients.[2] The practical effect is that many investment advisers to private funds now must register with the SEC, and many advisers with RAUM under the new floors must deregister in favor of oversight by the states.

Generally, small investment advisers – those with under $25 million of assets under management – cannot register with the SEC, unless the state in which they maintain their principal office and place of business has not enacted an investment adviser statute (e.g., Wyoming), or unless they act as an investment adviser to a registered investment company.

Mid-sized investment advisers that are *not* subject to registration and examinations as an investment adviser with the state in which they maintain their principal office and place of business generally must register with the SEC, unless an exemption applies.[3]

Mid-sized investment advisers that are subject to state registration and examination requirements generally cannot register with the SEC, unless they advise a registered investment company, or if they are required to register with more than 15 states.[4] Mid-sized investment advisers with assets under management of at least $100 million but less than $110 million (the upper buffer) may, but are not required to, register and need not withdraw SEC registration unless their assets under management fall to below $90 million (the lower buffer).[5]

Although Congress established a new floor of assets under management, it also created three new exemptions and an exception from the definition of an investment adviser.[6] These are for advisers to venture capital funds, advisers to "private funds" with less than $150 million under management, foreign private advisers, and family offices. Certain of these exemptions are discussed below.

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[2] The SEC revised instructions to Part 1A of Form ADV, the registration statement for investment advisers, "to implement a uniform method for advisers to calculate assets under management that will be used under the [Advisers] Act for regulatory purposes in addition to assessing whether an adviser is eligible to register with the Commission [SEC]." *Rules Implementing Amendments to the Investment Advisers Act of 1940*, SEC Rel. No. IA-3221, at 18-19 (June 22, 2011) (the "Implementing Release"). The SEC also altered the terminology used in Part 1A of Form ADV to refer to "an adviser's 'regulatory assets under management' in order to acknowledge the 'regulatory' purposes of this reporting requirement and to distinguish it from the assets under management disclosure that advisory clients receive in Part 2 of Form ADV." *Id.*, at 19-20.

[3] Mid-sized investment advisers in Wyoming (which does not require registration of investment advisers) and New York

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(which does not require regulatory examinations of investment advisers) may be required to register with the SEC, unless they qualify for another exemption from registration.

[4] Section 203A(a)(2)(A) of the Advisers Act provides that "No investment adviser described in subparagraph (B) shall register under Section 203, unless the investment adviser is an adviser to an investment company registered under the Investment Company Act of 1940, or a company which has elected to be a business development company pursuant to Section 54 of the Investment Company Act of 1940, and has not withdrawn the election, except that, if by effect of this paragraph an investment adviser would be required to register with 15 or more States, then the adviser may register under Section 203."

[5] Rule 203A-1(a)(1).

[6] For a more complete description, *see*, *e.g*., Kenneth W. Muller, Jay G. Baris, & Seth Chertok, *SEC Dodd-Frank Advisers Act Rulemaking: Part II*, 25 Insights: The Corp. & Sec. Law Advisor 9 (Sept. 2011); Jason E. Brown & Joel A. Wattenbarger, *Implementing the Private Fund Investment Advisers Registration Act of 2010*, 44 Rev. Sec. & Comm. Reg. 213 (Oct. 5, 2011).

Calculating RAUM

For U.S. advisers that manage traditional assets like stocks and bonds, it is fairly easy to determine registration obligations. But this requirement presents challenges for some advisers that manage nontraditional assets that, under the tangled web of federal securities laws, may be considered securities for some purposes, but not for others.

For purposes of determining an adviser's registration obligations, "assets under management" does not necessarily equal RAUM. Here, fine distinctions can become critical.

In calculating RAUM, an adviser must include "the securities portfolios for which you provide continuous and regular supervisory or management services" as of the date of the filing, disregarding the liabilities side of the balance sheet.[7] Advisers to certain accounts and private funds with mixed asset classes, however, must conduct a deeper analysis.

For example, the SEC considers an account to be a securities portfolio if at least 50 percent of the total value of the account consists of securities. Cash and cash equivalents may be counted as securities for this purpose, at the discretion of the adviser.[8] Moreover, advisers must include securities portfolios that are:

- family or proprietary accounts;
- accounts for which the adviser receives no compensation for its services; and
- accounts of clients who are not U.S. persons.

Multiple Classes of Assets under Management

Advisers may face challenges when accounts consist of multiple asset classes that include securities, derivatives, real estate, certain types of oil and gas interests, and certain types of limited partnership (LP) or limited liability company (LLC) interests. Under the old rules, advisers seldom faced these challenges, because they often relied on the "small adviser" exception, or other exemptions from registration. In the pre-Dodd-Frank days, advisers with fewer than 15 clients generally were exempt from registration, no matter how large their assets under management. A single fund with billions of dollars of assets counted as one client for this purpose.

With these issues now at the forefront of regulatory compliance inquiries, advisers may be required to analyze each asset held in an account to determine whether or not it is a security for purposes of determining registration requirements, a task that can prove quite challenging. Here are some examples of issues that advisers may now face:

- ***LP or LLC interests.*** The determination of whether LP or LLC interests are securities often depends on the level of involvement that the interest holders have in the affairs of the issuer. LP interests are deemed passive as a matter of law, and thus are securities. On the other hand, general partner interests are deemed to require active engagement by the interest holders, and thus generally are not considered securities. LLCs offer a greater range of considerations because members often exercise varying degrees of control over the entity's activities. For example, a member who has the right to approve LLC indebtedness, or remove a manager, likely will be found to maintain a significant level of control. In this case, the member's interests may not be considered securities, because active involvement may be imputed.[9] Advisers must carefully consider the specific relationship between the investor and the issuing entity when determining whether to include their LP and LLC interests in their RAUM calculations.

- ***Oil and gas interests.*** Generally, a "fractional undivided interest in oil, gas, or other mineral rights" is a security.[10] Under certain circumstances, however, these interests may not be so categorized. At least one court has held that isolated sales or assignments of oil and gas leases, or fractional parts

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[7] Form ADV: Instructions for Part 1A, item 5.b, *available at* http://www.sec.gov/rules/final/2011/ia-3221-appb.pdf.

[8] Cash and cash equivalents do not count as securities for other purposes, such as determining whether an issuer is an "investment company" under Section 3(a)(1) of the Investment Company Act of 1940.

[9] *See, e.g.*, *Robinson v. Glynn,* 349 F.3d 166 (4th Cir. 2003) (holding that an investor's membership interest in an LLC was not a security when the investor served as the LLC's treasurer and vice-chair of the LLC's board of managers and had negotiated for controls that allowed him to actively protect his interest, such as requiring his approval on LLC indebtedness); *but see Burnett v. Rowzee,* 2007 WL 2809769 (C.D.Cal. 2007) (holding that member authority to remove the manager of an LLC did not disqualify its membership interests from being securities).

[10] Section 202(a)(18) of the Advisers Act.

of those leases to specific persons, for example, did not qualify as sales of securities.[11]

- ***Real estate interests.*** A direct ownership interest in real estate (i.e., land) is not a security. An ownership interest in a partnership or LLC that owns land, however, generally will be a security unless the entity is wholly owned by a single investor or active participation in the management of the land can be demonstrated. To the extent that an investment provides similar indicia of ownership to that of actual real estate, that investment may fall outside the definition of a security. On the other hand, interests secured by or related to real estate that do not represent a direct interest in real estate generally are securities. Similarly, mortgages and other loans backed by real estate generally are securities.

Each of these situations may require an in-depth analysis of each investment to determine how it should be characterized for the purpose of determining whether an adviser crosses the threshold for SEC registration.

Advisers with No Regulatory Assets under Management

Some investment advisers may provide advice on securities, but may not have RAUM as defined by the SEC. For example, investment advisers who provide research to subscribers (who pay either in hard cash or "soft dollars") with no discretionary authority, and who provide no ongoing supervisory or management services, may be considered to have no RAUM.

One of the criteria for measuring RAUM is whether the investment adviser has an "ongoing responsibility to select or make recommendations, based upon the needs of the *client*, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the *client*, you [the adviser] are responsible for arranging or effecting the purchase or sale."[12] Thus, research reports alone do not form the basis of RAUM, even if clients ultimately rely and act upon the recommendations contained in those reports.

INVESTMENT COMPANY ACT CONSIDERATIONS AND THE "PRIVATE FUND" EXEMPTION

Advisers to pooled investment vehicles should review the statutory provisions on which their funds rely for exemption from registration under the Investment Company Act of 1940 (the "1940 Act"). In the pre-Dodd-Frank era, a fund typically relied on Section 3(c)(1) of the 1940 Act if it had fewer than 100 investors, or on Section 3(c)(7) if its investors were all qualified purchasers. By relying on these exemptions, funds previously avoided more difficult analyses of whether other exemptions were available.

In the post-Dodd-Frank world, however, these distinctions take on new significance as advisers attempt to determine whether their clients qualify as "private funds," which the Dodd-Frank Act defines as those relying on Sections 3(c)(1) and 3(c)(7). For example, funds may be able to utilize other available exemptions if they are in the commercial financing and mortgage banking business (Section 3(c)(5)), or if they are in the oil and gas business (Section 3(c)(9)). This distinction may take on significance for investment advisers that want to rely on the "private fund adviser" exemption and may have further ramifications for the reasons discussed below.

Some funds may fall entirely outside the definition of an investment company, although the status of these funds could be transitory with the shifting of its holdings.[13] Advisers taking the position that their funds are not "investment companies" should continuously review the status of the funds they manage under the statutory definition of investment company. Note that some of the exclusions and exemptions are measured at the time of acquisition.

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[11] *Woodward v. Wright,* 266 F.2d 108 (10th Cir. 1959) (noting that Congress intended to exclude such transactions from the scope of the federal securities laws, and to capture "only that form of splitting up of mineral interests which had been most utilized for speculative purposes"). For a discussion of when buying and selling interests in oil and gas properties by those regularly engaged in the oil and gas business should not be considered securities, *see* Peter K. Reilly and Christopher S. Heroux, *When Should Interests in Oil and Gas Be Considered Securities?: A Case for the Industry Deal*, 34 S. Tex. L. Rev. 37 (1993).

[12] Form ADV: Instructions for Part 1A, item 5.b(3)(b), *available at* http://www.sec.gov/rules/final/2011/ia-3221-appb.pdf.

[13] Section 3(a)(1)(C) of the 1940 Act includes within the definition of an "investment company" any entity that, as an issuer, is "engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis."

Advisers Solely to Private Funds with Less than $150 Million of Assets under Management

Although the Dodd-Frank Act eliminated the private adviser exemption, it created a new exemption from registration for advisers to "private funds" with less than $150 million in assets under management.[14] Generally, "qualifying private funds" are funds that would be investment companies but for the exemptions contained in Section 3(c)(1) or 3(c)(7) of the 1940 Act.[15]

The SEC adopted rules implementing this exemption, which created some unexpected side effects that implicate aspects of the 1940 Act.[16] For example, the SEC's rules do not disqualify an adviser from relying on this exemption if it also advises a fund that qualifies for another exemption available under Section 3 of the 1940 Act, such as real estate funds relying on the exemption provided in Section 3(c)(5)(C).[17] In effect, although the adviser does not "solely" advise private funds in this example, it can still avail itself of the exemption. An adviser relying on this provision, however, must treat the fund as a private fund for all purposes. These purposes would include reporting requirements under the Advisers Act. Presumably, these purposes may also include the anti-pyramiding restrictions contained in Section 12(d) of the 1940 Act, which, among other things, limit the amount of investments by registered investment companies in funds relying on the Section 3(c)(1) or Section 3(c)(7) exemptions.

[14] Section 408 of the Dodd-Frank Act added Section 203(m) of the Advisers Act, which created the exemption for advisers solely to private funds with less than $150 million of assets under management.

[15] Rule 203(m)-1 under the Advisers Act. A "qualifying private fund" means any private fund that is not a registered investment company (or has not elected treatment as a business development company). A private fund generally is a fund that is exempt from registration under the 1940 Act by virtue of the exemptions provided in Section 3(c)(1) or Section 3(c)(7). But, for purposes of this exemption, an adviser may treat as a private fund an issuer that qualifies for an exclusion from the definition of an investment company under any exemption available under Section 3 of the 1940 Act, provided that the adviser treats the issuer as a private fund for all purposes under the Advisers Act, e.g., for reporting purposes, as required by Item 7.B of Form ADV, Part 1A.

[16] *Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than $150 Million in Assets Under Management, and Foreign Private Advisers,* Release No. IA-3222 (June 22, 2011) ("Exemptions Release").

[17] Rule 203(m)-1(d)(5).

Advisers relying on this exemption ("exempt reporting advisers") must file certain reports with the SEC, including a limited subset of the information required by Form ADV that registered investment advisers must complete. The obligations of exempt reporting advisers are noted below.

NON-U.S. ADVISERS

The SEC historically has tried to strike a balance between limiting the extraterritorial application of the Advisers Act while protecting U.S. investors and markets.[18] The Dodd-Frank Act, however, has created new challenges for non-U.S. investment advisers, and U.S. securities laws and regulations may affect them in a number of unprecedented ways. This is especially true now that U.S. law generally looks to the nature and amount of assets under management, rather than the number of clients, when determining who must register as an investment adviser.

Non-U.S. investment advisers, even with no place of business in the United States and no U.S. clients, may potentially be subject to registration, unless exempt, provided they use sufficient "U.S. jurisdictional means" in connection with their advisory business or offering of securities. Moreover, non-U.S. investment advisers that use sufficient U.S. jurisdictional means may have to register, regardless of the amount of their RAUM, unless they qualify for an exemption from registration, as discussed below.

Generally, the test of jurisdictional means for non-U.S. investment advisers is whether there are "conducts or effects" in the United States.[19] Section 203(a) of the Advisers Act suggests that conducting business by using the U.S. mails or through use of U.S. interstate commerce is sufficient conducts or effects in the United States to require registration of an investment adviser (unless an exemption applies).[20]

[18] Exemptions Release, *supra* note 14, at 126; Division of Investment Management, SEC, *Protecting Investors: A Half Century of Investment Company Regulation,* May 1992 ("1992 Staff Report"), at 230-36, *available at* http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

[19] *See, e.g., The National Mutual Group*, 1993 SEC No-Act. LEXIS 384 (Mar. 1993). *See* discussion of how the courts and the SEC view "conducts and effects" below.

[20] Section 203(a) provides "Except as provided in subsection (b) and Section 203A, it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in

Thus, for example, a non-U.S. adviser with $30 million of assets under management of U.S. clients would have sufficient jurisdictional means, even if that adviser's principal office and place of business were located outside of the United States. This investment adviser would be required to register with the SEC because presumably it would not qualify as a "mid-sized" investment adviser (unless an exemption applies).

Why wouldn't this hypothetical adviser qualify as a mid-sized adviser? Because Section 203A of the Advisers Act provides that a mid-sized investment adviser, which is an adviser with assets under management between $25 million and $100 million, that is not subject to registration and examination requirements in a state in which it maintains its principal office and place of business, is required to register with the SEC. By definition, an adviser located outside the United States is not subject to state registration or examinations, and thus is swept into this requirement.

Non-U.S. investment advisers with sufficient jurisdictional means, such as the type described here, may qualify for one or more exemptions to registration, described above.

First, a non-U.S. adviser may qualify for the exemption for advisers solely to private funds with less than $150 million of assets under management provided by Section 203(m) of the Advisers Act, as discussed above.[21] For purposes of this exemption, an investment adviser with its principal office and place of business outside of the United States is exempt from the registration requirements if (1) the adviser has no client that is a U.S. person, except for one or more "qualifying private funds" and (2) all assets managed by the investment adviser at a place of business in the United States are solely attributable to private fund assets, with total value of less than $150 million.

Even though these non-U.S. advisers may be required to register, the SEC has consistently recognized that the substantive provisions of the Advisers Act generally should not govern the relationship between an investment adviser located outside the United States and its foreign clients.[22] And, as discussed below, the staff of the SEC has provided assurances that it would not recommend enforcement action, subject to certain conditions, against a non-U.S. unregistered adviser that is affiliated with an SEC-registered adviser, despite sharing personnel and resources.

Second, the Dodd-Frank Act created a new exemption for foreign private advisers.[23] A foreign private adviser is any investment adviser that (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients in the United States and/or investors in the United States in private funds advised by the investment adviser;[24] (iii) has aggregate assets under management 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; and (iv) does not hold itself out generally to the public in the United States as an investment adviser.

Unlike the exemption available for advisers solely to private funds with less than $150 million under management, the SEC requires advisers to "look through" nominees and similar arrangements to the underlying holders of private fund-issued securities to determine whether foreign advisers have fewer than 15 clients and investors in private funds in the United States.[25] For example, an adviser to a master fund in a master-feeder arrangement would have to look through to the investors in a feeder fund formed or operated for the purpose of investing in the master fund. That is, the SEC considers the holders of the securities of the feeder fund, not the feeder fund itself, to be the investor for purposes of determining an adviser's ability to rely on the foreign private adviser exception. Similarly, the SEC requires an adviser to count as an investor an owner of a total return swap on the private fund, because that

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connection with his or her business as an investment adviser." Section 202(10) of the Advisers Act defines interstate commerce as "trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof."

[21] Rule 203(m)-1(d)(1) provides that for purposes of this exemption, "assets under management" means RAUM.

[22] Implementing Release at 96; Exemptions Release at 127: "As we stated in 2004, we do not apply most of the substantive provisions of the Advisers Act to the non-U.S. clients of a non-U.S. adviser registered with the Commission."

[23] Section 402 of the Dodd-Frank Act (providing a definition of "foreign private adviser," to be codified at Section 202(a)(30) of the Advisers Act).

[24] Rule 202(a)(3)-1 defines "clients in the United States" and "investors in the United States" in private funds for purposes of this exemption. For example, a limited partnership formed in Delaware would be a "client in the United States" whether or not its interests are held by U.S. investors.

[25] Exemptions Release, *supra* note 16, at 108.

contractual arrangement "effectively provides the risks and rewards of investing in the private fund to the swap owner."[26]

Non-U.S. Affiliates of U.S. Advisers

The SEC's Division of Investment Management has reaffirmed its position that it would not recommend enforcement action, subject to certain conditions, against an unregistered non-U.S. adviser that is affiliated with a U.S. registered adviser (a "participating affiliate"), despite sharing personnel and resources.[27] Moreover, the SEC staff has taken the position that it would not recommend enforcement action of the substantive provisions of the Advisers Act with respect to a non-U.S. adviser's relationships with its non-U.S. clients.[28] These positions were developed in the context of the private adviser exemption from registration, which the Dodd-Frank Act repealed.[29] While the SEC said that it did not intend to withdraw the staff's guidance, this guidance must be viewed in the context of the Dodd-Frank Act, which creates new challenges for non-U.S. advisers, particularly those with U.S. persons as investors in the funds they manage.

The SEC staff has stated that it would not recommend enforcement action against an investment adviser that files a single Form ADV (a "filing adviser") on behalf of itself and each other adviser that is controlled by or under common control with the filing adviser and registered through a single registration with the filing adviser (each, a "relying adviser"), when the filing adviser and each relying adviser collectively conduct a single advisory business, subject to certain conditions.[30]

The filing adviser, however, in the staff's view, must have its principal place of business in the United States. Thus, all of the substantive provisions of the Advisers Act apply to the filing adviser's and each relying adviser's dealings with each of its clients, regardless of whether any client of the filing adviser or relying adviser providing the advice is a U.S. person. The staff is concerned that, absent this limitation, a group of related advisers based inside and outside of the United States could designate a non-U.S. adviser as a filing adviser, and assert that the Advisers Act's substantive provisions generally would not apply to the U.S.-based relying adviser's dealings with its non-U.S. clients.

Non-U.S. Advisers and the Antifraud Provisions

Some non-U.S. advisers may employ U.S. jurisdictional means, but their activities do not rise to the level of requiring them to register. However, the antifraud provisions of the federal securities laws may apply even if registration is not required. Historically, the SEC and the courts looked to whether the activities of the non-U.S. adviser produced substantial and foreseeable effects in the United States or involved conduct in the United States, even if the activity had no effect on U.S. persons or U.S. markets. This is the so-called "conducts and effects" test that the courts used for asserting jurisdiction under the antifraud provisions of federal securities laws.

In 2010, the U.S. Supreme Court jettisoned that test and held that the antifraud provisions of U.S. securities laws do not apply to non-U.S. plaintiffs who sue non-U.S. defendants for fraud relating to securities transactions on non-U.S. exchanges.[31] Shortly after the decision, Section 929P(b) of the Dodd-Frank Act amended Section 214 of the Advisers Act (and other parts of the federal securities laws) to authorize the SEC to commence enforcement actions alleging violations of the Advisers Act's antifraud provisions involving (1) "conduct within the United States that constitutes significant steps in furtherance of the violation, even if the violation is committed by a foreign adviser and involves only foreign investors," or (2) "conduct occurring outside the United States that has a foreseeable substantial effect within the United States." In substance, Congress restored the "conducts and effects" test for SEC actions, but not for private actions. Thus, non-U.S. advisers should be aware that the long arm of U.S. law may reach them in matters of alleged fraud that involve conduct in the United States or that affect the U.S. markets.[32]

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[26] *Id.* at 109.

[27] *Id.* at 125-128.

[28] *Id.* at 125-128, citing *Uniao de Bancos de Brasileiros S.A.*, SEC Staff No-Action Letter (July 28, 1992).

[29] *Id.* at 127-128.

[30] American Bar Association, Business Law Section, *Response of the Office of Investment Adviser Regulation Division of Investment Management* (Jan. 18, 2012), *available at* http://www.sec.gov/divisions/investment/noaction/2012/aba011812.htm.

[31] *Morrison v. National Australia Bank Ltd.*, 130 S. Ct. 2869 (2010). For a discussion of *Morrison*'s application, *see* Alex C. Lakatos, *Extraterritorial Section 10(b) Class Actions after Morrison*, 45 Rev. Sec. & Comm. Reg. 61 (Mar. 21, 2012).

[32] *See* 1992 Staff Report, *supra* note 18, at 227.

Prior to Dodd-Frank, the SEC took the position that non-U.S. advisers to non-U.S. clients may, without registering under the Advisers Act, use U.S. jurisdictional means to acquire information about securities of U.S. issuers through U.S. brokers or dealers, for the benefit of the adviser's clients, but may be subject to U.S. antifraud laws under the Advisers Act.[33] In contrast, a U.S. adviser dealing exclusively with foreign clients must register under the Advisers Act if it uses any jurisdictional means in connection with its advisory business, unless an exemption applies.

Consistent with its pre-Dodd-Frank position, the staff recently said that it would not recommend enforcement action against a Canadian investment adviser that does not register as an investment adviser on the basis that:

- the adviser's principal office and place of business is in Canada, and it has no office or place of business in the United States;
- the adviser's only U.S. clients are certain U.S. insurance companies that are direct or indirect wholly owned subsidiaries of the adviser's Canadian parent company; and
- the adviser only uses U.S. jurisdictional means for the purpose of acquiring information about the securities of U.S. issuers and effecting transactions in securities of U.S. issuers through U.S. brokers and dealers.[34]

Investment advisers that rely on any of the new exemptions from registration created by the Dodd-Frank Act are still subject to certain provisions of U.S. law. For example, advisers who qualify as "foreign private advisers," advisers that advise solely private funds with less than $150 million under management in the United States, and advisers solely to venture capital funds nonetheless are subject to the federal securities laws' antifraud provisions and certain restrictions on trades with clients, among others. Advisers who rely on the foreign private adviser's exemption must also comply with the SEC's pay-to-play rules.[35] Advisers that rely on the private fund or venture capital fund adviser exemptions are also subject to exempt reporting adviser requirements, described below.

CUSTODY ISSUES

One unintended consequence of the Dodd-Frank Act can be seen in the context of compliance with the SEC's custody rules.

The amended custody rules are designed to safeguard investors when a registered adviser has custody of client funds or securities. Among other things, these rules require advisers to "[i] undergo an annual surprise examination by an independent public accountant to verify client assets; [ii] have the qualified custodian maintaining client funds and securities send account statements directly to the advisory clients; and [iii] unless client assets are maintained by an independent custodian (i.e., a custodian that is not the adviser itself or a related person), obtain, or receive from a related person, a report of the internal controls relating to the custody of those assets from an independent public accountant that is registered with and subject to regular inspection by the Public Company Accounting Oversight Board. Finally, the amended custody rule and forms will provide the SEC and the public with better information about the custodial practices of registered investment advisers [under the Advisers Act]."[36]

In the pre-Dodd-Frank days, compliance life was a bit simpler. Registered investment advisers followed relatively straightforward rules governing custody of client assets. Advisers to private equity funds and hedge funds did not often worry about the custody rules, because many of those advisers relied on the "private adviser" exemption from registration.

For advisers to hedge funds and private equity funds that invest in plain vanilla securities, compliance with the custody rules is simple. But many private funds hold assets that are not plain vanilla. These asset classes may include interests in real estate, oil and gas, LLCs and

[33] *Gim-Seong Seow*, SEC Staff No-Action Letter (Nov. 30, 1987); *Double D. Management, Ltd.*, SEC Staff No-Action Letter (Jan. 31, 1983); and *BOH Investment Management Co. (Hong Kong) Limited*, SEC Staff No-Action Letter (Jan. 2, 1987).

[34] *Industrial Alliance, Investment Management, Inc.*, SEC Staff No-Action Letter (Mar. 14, 2012).

[35] Generally, Rule 206(4)-5, which restricts political contributions by certain investment advisers, applies to investment advisers registered (or required to be registered) with the SEC, and

footnote continued from previous column…

unregistered investment advisers who rely on the foreign private adviser exemption provided in Section 203(b), who provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the U.S. state government entity is made by the investment adviser or any covered associate of the adviser.

[36] *Custody of Funds or Securities of Clients by Investment Advisers*, Inv. Adv. Rel. 2968, at 1 (Dec. 30, 2009).

LPs, and other types of interests that may be considered securities, even though they lack the characteristics of traditional securities. For example, as previously noted, a fractional oil and gas interest most likely qualifies as a security, but ownership typically is reflected in a deed recorded in the county clerk's office, rather than in a share certificate or uncertificated form that a custodian can hold. Advisers to these funds that previously were exempt from registration did not worry about these custody issues, but under the amended rules will be required to evaluate their custodial practices once they register with the SEC.

Recent SEC Guidance on Custody for Broker-Dealers

The Division of Trading and Markets recently provided guidance about how broker-dealers can satisfy the requirement that they physically hold securities of their clients. This guidance implicitly acknowledged the difficulty in establishing possession and control of uncertificated securities, because a broker-dealer cannot hold them physically.[37]

Broker-dealers that hold securities for the account of customers must maintain physical possession or control of all fully paid and margin securities. This requirement means that broker-dealers must have securities in their physical possession at one or more "control locations." The staff of the Division of Trading and Markets, in the context of the requirement that broker-dealers must maintain control, has taken steps to recognize the difficulty of keeping track of alternative investments, including certain uncertificated securities. For example, in the *Charles Schwab & Co.* no-action letter, the staff said that it would not recommend enforcement action if a broker-dealer utilized the Alternative Investment Products service of the National Securities Clearing Corporation as a satisfactory control location for uncertificated shares of alternative investments, of which it is required to keep physical possession on behalf of its clients.[38]

Although this no-action letter applies only in the broker-dealer context and not in the context of the custody requirements of the Advisers Act, it is significant because it shows a willingness to establish an alternative method to satisfy the physical possession requirements that apply to broker-dealers. We hope and expect that the SEC will extend the concepts addressed in this no-action letter to the custody requirements applicable to investment advisers.

EXEMPT REPORTING ADVISERS

"Exempt reporting advisers" do not have to register with the SEC, but they are nonetheless subject to certain SEC substantive requirements. Exempt reporting advisers include advisers that advise solely one or more venture capital funds, or that act solely as an adviser to private funds and have less than $150 million of assets under management in the United States.

Exempt reporting advisers must file a portion of Form ADV and periodic reports disclosing, among other things, control persons, disciplinary history, and assets under management – information they were not required to disclose previously. Moreover, exempt reporting advisers may also be required to register or file reports with state securities regulators.[39]

WHISTLEBLOWERS

Section 922(a) of the Dodd-Frank Act amended the Securities Exchange Act of 1934 to add incentives and protections for whistleblowers. Whistleblowers who voluntarily supply "original information" to the SEC that results in a recovery greater than $1 million will receive a reward. The SEC's Form TCR contemplates anonymous complaints about investment advisers, including allegations of misrepresentations, omissions, false or misleading marketing or sales literature, or inaccurate or misleading disclosures, among other things.[40] Investment advisers should ensure that their compliance procedures address potential whistleblower situations.[41]

CONCLUSION

The Dodd-Frank Act and its implementing regulations have created some nuanced issues and potential pitfalls for investment advisers, both inside and outside the United States. The deadlines for compliance

[37] *Charles Schwab & Co.*, SEC Staff No-Action Letter (Feb. 3, 2012).

[38] *Id.*

[39] *Form ADV: General Instructions*, item 14, at 8; Implementing Release, *supra* note 2, at 170.

[40] *Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934*, Rel. No. 34-64545, at 289-91 (May 25, 2011).

[41] For a detailed discussion of the SEC's final rules, *see* Laurence S. Lese & Michael E. Clark, *Insights into the SEC's Whistleblower Program*, 44 Rev. Sec. & Comm. Reg. 225 (Oct. 19, 2011).

have passed. Nonetheless, advisers should undertake a comprehensive review of their structures and client base to determine their registration obligations and to ensure that they do not inadvertently violate a provision of the Advisers Act or any other aspect of U.S. law that may apply to them. Advisers that must register with the SEC should carefully design and implement a compliance program to tackle some of the potentially murkier issues, such as custody and reporting obligations that they have not previously had to address.

Beyond this, whether or not they must register under the Advisers Act, advisers should establish a culture of compliance, because they are subject to varying levels of regulatory oversight, and because the regulators are focused on their actions. Advisers to hedge funds and private equity funds have for years flown under the regulatory radar. Now, they are experiencing a level of regulatory scrutiny that can seem alien and burdensome. Establishing a compliance program with an experienced chief compliance officer should be a priority.■