Chapter 1

Regulation of Investment Advisers

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1.1 Regulation and registration of the global investment manager

In the last decade, while the investment management industry has become more globally focused, the regulation of investment advisers has not kept pace. Investment advisers seeking to do business across borders still face a maze of competing and antiquated jurisdictional regulations and laws that have not matched dynamic changes in the global marketplace. Indeed, an investment adviser today may become subject to limited extraterritorial jurisdiction without expecting it. In fact, in some cases, whether a local regulator will assert jurisdiction over a foreign adviser may be unclear even to local counsel.

Thus it is wise for non-US investment advisers to have a basic understanding of the regulatory and registration requirements of the US, where the securities regulations are among the most restrictive in the world and where the regulator – the US Securities and Exchange Commission ("SEC") – has sought expansive jurisdictional authority over non-US investment advisers.

In determining the extent of its potential exposure to US regulation, a non-US adviser should first consider the following questions, which will be discussed in greater detail in this chapter, and also throughout the book:

- Does the adviser have any US clients?
- If so, what type of clients are they, and does any client's status create any specific jurisdictional issues?
- Does the adviser have a US affiliate, and, if so, is the US affiliate required to be registered under the US Investment Advisers Act of 1940 (the "Advisers Act")?
- Does the adviser market its services to prospective US clients?
- Does the adviser market its funds or other products to prospective US investors?
- Does the adviser or an affiliate also act as a broker-dealer and/or execute trades for US clients?

The answers to these questions will determine:

(a) whether the adviser is subject to US regulation;
(b) whether the adviser is required to register with the SEC as an adviser or broker-dealer; and
(c) what type of US-oriented compliance regime the adviser should institute.

1.1.1 US regulation/the investment adviser definition

It is important first to note the distinction between a "registered" investment adviser and a "regulated" investment adviser. While only a certain sub-category of investment advisers must be *registered*, the SEC asserts the authority to *regulate* all "investment advisers", as that term is defined in Section 202(a)(11) of the Advisers Act:

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

While each element of this definition of the term "investment adviser" will be discussed in greater detail in Section 1.2.1 of this chapter, it is important to note the broadness of the definition, which covers, on its face, both registered and unregistered entities, as well as

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both US and non-US entities. Thus, it is important for a non-US adviser seeking to manage assets of one or more US clients[1] to understand whether such adviser falls within the definition of investment adviser under the Advisers Act in order to consider the extent to which it should apply US regulations to its operations.

On a final definitional note, it is important to recognise that US regulation – as opposed to a number of non-US jurisdictions – does not make a distinction between investment "managers" and investment "advisers". The term "investment adviser" in the Advisers Act covers discretionary and non-discretionary investment activities.

1.2 The requirement to register

An entity meeting the Advisers Act definition of an "investment adviser" must register with the SEC, unless an exemption applies.

1.2.1 The elements of the "investment adviser" definition

The first inquiry into whether an entity must register with the SEC is whether that entity meets the definition of "investment adviser" under Section 202(a)(11) of the Advisers Act, as described in Section 1.1.1 above. If an entity is not an "investment adviser", the entity need not register. If an entity *is* an investment adviser, as defined in the Advisers Act, the entity may still be exempt from registration under other provisions.

In determining whether an entity is an investment adviser, it is necessary to understand each of the following elements of the Advisers Act definition of "investment adviser":

- "in the business";
- "of advising others";
- "concerning securities"; and
- "for compensation".

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[1] For a discussion of who is a US client, *see infra* Section 1.7.1.

1.2.1.1 In the business

The SEC has stated that this element of the definition is a question of "degree". While a person may be deemed an investment adviser even if the giving of investment advice is not the person's *principal* business activity, the person will not fall within the definition of investment adviser if the investment advice is offered only in "rare, isolated and non-periodic instances."[2] The SEC has also stated that a person may be "in the business" if the person:

(a) holds itself out as an investment adviser; or
(b) receives any separate or additional compensation that represents a clearly definable charge for providing advice about securities. (How a person might hold itself out as an investment adviser is discussed in Section 1.2.3 below.)

1.2.1.2 Advising others

The SEC's staff ("SEC staff") has concluded that if an individual or entity manages only its own assets – or the assets of wholly owned "affiliates" of the adviser's ultimate parent – then the entity would not be advising "others" and the entity would not be considered to be an investment adviser.[3]

1.2.1.3 Concerning "securities"

If the advice offered by a person does not relate to "securities", as that term is defined under the Advisers Act, the entity would not be considered to be an investment adviser and, therefore, need not register. While seemingly simple, the question of "what is a security?" has been the subject of numerous, and at times contradictory, decisions in the US courts. Thus, this chapter does not contain a full discussion of this question.[4] Clearly, debt, equity and commingled fund interests generally constitute securities. A more expansive list can be found in Section 202(a)(18) of the Advisers Act.

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2 *Applicability of the Investment Advisers Act to Financial Planners, Pension Consultants, and Other Persons Who Provide Investment Advisory Services as a Component of Other Financial Services,* Release No IA-1092 (8 October 1987) ("Release No 1092") at n 9 (citing *Zinn* v *Parish,* 644 F 2d 360 (7th Cir 1981)).

3 *Lockheed Martin Investment Management Company* (pub avail 5 June 2006).

4 *See,* e.g., J Christian Nahr, "What is a Security for Purposes of the US Federal Securities Laws?" 17 Am U Int'l L Rev 723 (2002).

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The SEC deems the following persons to be providing advice on securities pursuant to the Advisers Act:

(a) a person who, with respect to *specific* securities, gives advice, issues reports or analyses, or has the discretion to make investment decisions for others;
(b) a person who gives advice as to the desirability of investing in, purchasing or selling securities generally, but which does not relate to specific securities; and
(c) a person providing advice or discretionary services to a client as to the selection of an investment adviser or advisers.[5]

Information that simply describes or explains various investment options, for example, information provided by an employer to its employees regarding options available through an employee benefit plan, without including any recommendation with respect to those options, may not constitute "investment advice".[6]

1.2.1.4 For compensation

An investment adviser is deemed to be receiving compensation for investment advisory activities if the person is the recipient of "any economic benefit". This might be a separate investment advisory fee or a single fee for a package of services that *includes* advisory services.[7] In addition, the economic benefit can be received from any source and not just necessarily from "the persons receiving investment advice".[8]

1.2.2 Exclusions from the definition of "investment adviser"

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The following types of persons are specifically excluded from the definition of "investment adviser" in spite of meeting all of the elements described above:

(a) a US-regulated bank, or bank holding company, other than a bank or bank holding company that acts as an investment adviser to a US-registered investment company;

[5] Release No 1092, *supra* fn 2.
[6] *US Department of Labor* (pub avail 22 February 1996).
[7] Release No 1092, *supra* fn 2, at n 8 (citing *FINESCO* (pub avail 11 December 1979)).
[8] Id at n 9 (citing *Warren H Livingston* (pub avail 8 March 1980)).

(b) any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession;
(c) any broker or dealer[9] whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation;
(d) the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; and
(e) any person whose advice, analyses or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the US, or corporations in which the US has a direct or indirect interest.[10]

1.2.3 The elements of the registration requirement

A non-US person meeting the definition of investment adviser must generally register with the SEC if the person also meets any *one* of the following elements and is not otherwise exempt from registration (*see* Section 1.3 below):

(a) during the course of the preceding 12 months the person has had more than 14 clients; *or*
(b) the person holds itself out generally to the US public[11] as an investment adviser; *or*
(c) the person acts as an investment adviser to at least one US-registered investment company.[12]

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[9] The SEC staff has expressed the view that foreign broker-dealers that are exempt from registration as broker-dealers under Rule 15a-6 of the US Securities Exchange Act of 1934 are also exempt from the definition of "investment adviser" in the Advisers Act "if they provide investment advice solely incidental to their brokerage business and receive no special compensation for it." *Registration Requirements for Foreign Broker-Dealers*, Exchange Act Rel No 27017 (11 July 1989). *See also* e.g. *Charterhouse Tilney* (pub avail 15 July 1993).
[10] Section 202(a)(11)(A)–(F) of the Advisers Act.
[11] While the Advisers Act does not specifically clarify that the term "public" is limited to the US public, the SEC staff has made this point clear. *See*, e.g. *Kleinwort Benson Investment Management Limited* (pub avail 15 December 1993).
[12] Section 203(b) of the Advisers Act.

1.2.3.1 More than 14 clients

A non-US investment adviser who has no US adviser affiliate (or is independent from its US adviser affiliate) need count *only* its US clients in making this determination.[13] For example, if such an adviser had 13 French clients and two US clients, the SEC would count only the two US clients, and registration on this basis would not be required. Note that this is different from the method the SEC would use to count the number of clients of a US-domiciled investment adviser.[14]

For these purposes, the following entities constitute a single client:

(a) A natural person, and
  - (i) any minor child of the natural person;
  - (ii) any relative, spouse, or relative of the spouse of the natural person who has the same principal residence;
  - (iii) all accounts of which the natural person and/or the persons referred to above are the only primary beneficiaries; and
  - (iv) all trusts of which the natural person and/or the persons referred to above are the only primary beneficiaries;

(b) A corporation, general partnership, limited partnership, limited liability company, trust (other than a trust referred to above), or other legal organisation to which an adviser provides investment advice based on its investment objectives rather than the individual investment objectives of its shareholders, partners, limited partners, members, or beneficiaries (any of which are referred to hereinafter as an "owner"); and

(c) Two or more legal organisations (i.e. corporations, partnerships, etc.) that have identical owners.[15]

1.2.3.2 Holding out

"Holding out" to the US public has been very broadly defined to include a person:

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[13] Rule 203(b)(3)-1(b)(5) under the Advisers Act.

[14] A US-domiciled adviser must count every one of its clients, US and non-US, in determining whether it has more than 14 clients. Rule 203(b)(3)-1(b)(5) under the Advisers Act; *Gim-Seong Seow* (pub avail 30 November 1987).

[15] Rule 203(b)(3)-1(a) under the Advisers Act.

(a) advertising its investment advisory services;
(b) referring to itself as an "investment adviser";
(c) maintaining a listing as an investment adviser in a telephone, business, building or other directory;
(d) using letterhead indicating any investment advisory activity; or
(e) letting it be known, through word of mouth or otherwise, that it is willing to provide investment advisory services.[16]

A non-US adviser would be deemed to have held itself out to the US public by advertising from its local jurisdiction on a website, unless it took adequate measures to prevent the information from being directed to the US. The SEC would generally consider an adviser to have "implemented measures reasonably designed to guard against holding itself out as an investment adviser in the US" if the website includes a prominent disclaimer making it clear to whom the site materials are (or are not) directed; or the adviser implements procedures reasonably designed to guard against directing information about its advisory services to US persons (e.g. obtaining sufficient residence information prior to making available further information, other than to its US clients).[17]

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1.2.3.3 Assets under management

US persons with greater than 14 clients or holding themselves out to the public as an investment adviser must also have at least $30 million in assets under management before being required to register with the SEC. The $30 million threshold applies only to advisers with a principal office in any state or possession of the US,[18] not to an adviser whose principal office and place of business is in a non-US jurisdiction. Such an investment adviser must register with the SEC "regardless of the amount of assets under management."[19] Under certain circumstances, a US state may impose certain licensing or registration requirements on an investment adviser who is not required to register

[16] Division of Investment Management: Staff Legal Bulletin No 11, "Applicability of the Advisers Act to Financial Advisors of Municipal Securities Issuers", at n 18 (19 September 2000) (citing *DZP Associates* (pub avail 19 November 1976)).

[17] *Statement of the Commission Regarding Use of Internet Web Sites to Offer Securities, Solicit Securities Transactions, or Advertise Investment Services Offshore*, Rel No IA-1710 (27 March 1998).

[18] Rule 203A-1(a) under the Advisers Act.

[19] *Electronic Filing By Investment Advisers; Proposed Amendments to Form ADV*, Rel No IA-1862, at n 73 (5 April 2000).

under the Advisers Act but who has a place of business in the state, has more than five clients that are natural persons, and more than 10 per cent of whose clients are natural persons.[20] (For information on state regulation of advisers, *see* Chapter 14.)

1.3 Exemptions from registration

An investment adviser that meets the requirement for registration described above (i.e. a person that meets the Advisers Act definition of an investment adviser), nevertheless can avoid registration if the investment adviser fits within one of the following categories:

(a) a person whose only clients are insurance companies;
(b) a charitable organisation that does not manage the assets of a US-registered investment company;
(c) a church employee retirement plan that does not manage the assets of a US-registered investment company;
(d) an adviser registered with the US Commodity Futures Trading Commission ("CFTC") as a commodity trading advisor that does not act primarily as an investment adviser and that does not manage the assets of a US-registered investment company;[21] and
(e) a non-US investment adviser that

  (i) is integrated in the business of its US-registered investment adviser affiliate, and
  (ii) relies on and complies with the conditions of the "Participating Affiliate" series of no-action letters issued by the SEC staff (as described more fully in Chapter 6).[22]

1.4 US regulation of registered, non-US advisers

A registered, non-US adviser must comply with the Advisers Act with respect to the firm's clients who are US persons. However, the Advisers Act does not apply in its entirety to a registered, non-US adviser's management of its non-US clients, as the following conditions illustrate:

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[20] Rule 203A-3(a) under the Advisers Act.
[21] Section 203(b) of Advisers Act.
[22] *Murray Johnstone Holdings Ltd* (pub avail 7 October 1994).

(a) the adviser must comply with all Advisers Act recordkeeping requirements with respect to its US clients and certain recordkeeping requirements with respect to its non-US clients;[23]
(b) the adviser may not hold itself out to its non-US clients as being registered under the Advisers Act and communications with non-US clients may not indicate that the adviser is registered under the Advisers Act;
(c) where communications are sent out by the adviser to all clients, separate communications must be sent by the adviser to non-US clients, and, in communications with non-US clients, either references to the adviser's registration must be deleted or the communication must make it clear that the adviser complies with the Advisers Act only with respect to its US clients;
(d) the adviser must promptly provide to the SEC upon receipt of an administrative subpoena, demand, or a request for voluntary cooperation made during a routine or special inspection or otherwise, any and all required books and records;
(e) the adviser must promptly make all relevant personnel available for testimony before, or other questioning by, the SEC upon receipt of an administrative subpoena, demand, or a request for voluntary cooperation made during a routine or special inspection or otherwise; and
(f) the adviser must list on its Form ADV all of its directors and each portfolio manager who provides advice to US clients.[24]

This is very different from the requirements applicable to a US-domiciled investment adviser, who generally must comply with US securities laws, even with respect to its non-US clients.

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1.5 US regulation of unregistered, non-US advisers

A non-US adviser managing the accounts of one or more US clients technically would fall within the plain meaning of the Advisers Act definition of "investment adviser". If the non-US adviser has a US

[23] A registered, non-US adviser may decline to comply with Rules 204-2(a)(3), (7)–(11), (14), (15) and (16) and Rule 204-2(b) under the Advisers Act with respect to its non-US clients. *See infra* Chapter 4. For more information about the "lite registration" requirements applicable to a registered, non-US adviser's duties with respect to its non-US hedge funds, *see* Chapter 8.
[24] *Mercury Asset Management plc* (pub avail 16 April 1993).

advisory affiliate with which its investment operations are integrated, it must either register with the SEC as an investment adviser or avoid registration with the SEC by using the "Participating Affiliate" approach discussed below. In either case all of the non-US adviser's activities vis-à-vis its US clients will be subject to regulation by the SEC.

But, what of the investment adviser that (a) has a small number of US clients, (b) has no real nexus with the US and (c) is exempt from US registration? On the one hand, the SEC and its staff generally have been silent as to whether they would seek to apply the requirements of the Advisers Act to an unregistered, non-US adviser managing a small number of US clients from offshore. To date, the SEC has not taken any action against an unregistered, non-US adviser and any such action – although technically permissible under the Advisers Act[25] – would be very difficult to enforce in US or non-US courts. Moreover, we are not aware of any private cause of action against an unregistered, non-US adviser grounded in violations of the Advisers Act under these circumstances.[26] On the other hand, the SEC has sought to expand its global reach in certain instances. For example, in a rulemaking that was recently overturned by a US federal court,[27] the SEC attempted to expand its jurisdiction over non-US advisers of non-US hedge funds having US investors, evidencing its determination to assert a global role where it deems it necessary for the protection of US investors and markets.[28]

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Despite the clear difficulty with enforcement, given the SEC's interest in protecting US investors (and the technical language of the Advisers Act), each unregistered, non-US adviser that provides advice to US clients should consider whether to comply with US regulation and practice with respect to its US clients to the extent required of an unregistered US-domiciled adviser. In this regard, the only Advisers Act provisions that apply to unregistered investment advisers are the anti-fraud provisions of Section 206 and some of the Rules thereunder

[25] Section 203(b) of the Advisers Act.
[26] A private cause of action under the Advisers Act is very limited. *TransAmerica Mortgage Advisors, Inc* v *Lewis*, 444 US 11 (1979).
[27] *Goldstein* v *SEC*, 451 F 3d 873 (DC Cir 2006). For a fuller discussion of SEC regulations and non-US hedge fund advisers, *see* Chapter 8.
[28] *See*, e.g., *Cleary, Gottlieb, Stein & Hamilton* (pub avail 9 April 1997).

and the SEC and SEC staff pronouncements relating thereto,[29] which impose a fiduciary duty on every adviser, registered or not.[30]

The requirement not to commit fraud is common in regulated jurisdictions, and, at their most basic, an adviser's duties under Section 206 are:

(a) to put clients' interests first;
(b) to act with utmost good faith;
(c) to provide full and fair disclosure of all material facts;
(d) not to mislead clients; and
(e) to disclose all conflicts of interest to clients.[31]

However, the specific requirements derived from Section 206 are quite well developed and, in some cases, unique. For example, an unregistered, non-US adviser that chooses to comply with the Advisers Act with respect to its US clients would:

(a) comply with the requirements of Section 206(3) regarding principal trades;[32]
(b) seek "best execution" of client trades;[33]
(c) comply with the disclosure requirements that are rooted in Section 206;[34] and
(d) comply with US soft dollar requirements[35] (unless the requirements of the adviser's home jurisdiction are more restrictive than the US requirements).

Thus, a non-US adviser might have to trade separately for its US clients, which might have a detrimental effect on the performance for those client accounts.

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29 The SEC has written that "[t]he anti-fraud provisions of Section 206 of the Advisers Act and the rules adopted by the [SEC] thereunder, apply to any person who is an investment adviser as defined in the Advisers Act, whether or not the person is required to be registered . . . as an investment adviser." Release No 1092, *supra* fn 2.

30 *SEC* v *Capital Gains Research Bureau, Inc*, 375 US 180 (1963).

31 Lori A Richards, Director, Office of Compliance Inspections and Examinations, SEC, "Fiduciary Duty: Return to First Principles", Address at the Eighth Annual Investment Adviser Compliance Summit (27 February 2006).

32 *See infra* Chapter 2, Section 2.7.

33 *See infra* Chapter 2, Section 2.8.1. *Morgan, Lewis & Bockius LLP* (pub avail 16 April 1997) (reference to relationship between Section 206 and the best execution requirement).

34 *See infra* Chapter 2, Section 2.1.

35 *See infra* Chapter 2, Section 2.8.2.

An unregistered, non-US adviser should bear in mind in when using this book – for example, when reviewing the compliance obligations described in Chapter 2 – that outside of Section 206, the Advisers Act does not apply to such advisers. Nevertheless, regardless of what compliance regime an unregistered, non-US adviser chooses to create, obtaining a basic knowledge of US asset management regulation is inevitably useful in understanding the expectations and perspectives of the US client.

1.6 The registration process and registration requirements

Compared to the registration requirements of many non-US jurisdictions, those imposed by the SEC are fairly simple. An adviser registration consists of two documents: Form ADV Part I, which is filed electronically with the SEC, and Form ADV Part II, which currently is not required to be filed electronically.[36] The Form ADV Part II or the client brochure containing the information required by Form ADV Part II is often referred to as the adviser's "brochure". The SEC website provides detailed information on filing Part I and completing Part II, which applies to any adviser seeking registration with the SEC, as well as answers to frequently asked questions. Within 45 days after filing of the Form ADV Part I, the SEC must either approve the registration or institute a proceeding to determine whether to deny registration. The information included in the Form ADV Part I must be accurate and will be reviewed in detail when the SEC staff inspects the adviser. Form ADV Part I is available to the public through the SEC's website and Form ADV Part II, or a client brochure containing the information required to be included in Form ADV Part II, must be delivered to clients at least 48 hours prior to the signing of the investment advisory contract.[37] On an annual basis, the investment adviser must offer to deliver the ADV Part II to the client at no charge.

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[36] Electronic filing of Form ADV Part II is currently optional.

[37] Rule 204-3(b) under the Advisers Act. Alternatively, the ADV Part II may be delivered at the time of execution of the advisory contract if the client has a right to terminate the contract, without penalty, within five business days after entering into the contract. Id.

The ADV Part II is usually also provided to US investors in US unregistered funds, although some argue that this is not technically required under the rule. It is not common practice to provide the ADV Part II to investors in a non-US fund, although an adviser might consider offering it. In any event, a fund's offering document should provide information material to investors that is included within the ADV Part II, rendering the ADV delivery redundant in the case of non-US funds.

The following summary highlights information that should prove useful to a non-US adviser seeking US registration:

(a) the SEC requires an initial set-up fee, followed by an annual updating fee that is paid when the ADV is updated, both of which are de minimis, and based on the adviser's assets under management. In order to pay the necessary fees, the investment adviser must set up an account through the Investment Adviser Registration Depository;[38]

(b) a non-US adviser must designate the SEC as agent for service of process;[39]

(c) a non-US adviser must either designate a US address where its required books and records will be kept or provide an undertaking to the SEC to provide such books and records to the SEC at its own expense within 14 days of SEC demand;[40]

(d) amendments to the Form ADV Part I are required to be filed no less frequently than once a year, within 90 days after the end of the adviser's fiscal year, and must be filed promptly for certain changes to Form ADV if:

    (i) information the adviser provided in response to Items 1, 3, 9 and 11 of Part IA or Items 1, 2A through 2F or 2I of Part IB becomes inaccurate in any way. These items refer to identifying information, form of organisation, custody of client assets, disclosure information, persons responsible for supervision/compliance, bond/capital information, judgment/lien information, arbitration, civil judicial actions, and custody of client accounts;[41] or

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38 *See* http://www.iard.com/fee_schedule.asp.
39 Rule 0-2 under the Advisers Act.
40 Rule 204-2(j) under the Advisers Act.
41 *See* Appendix A to this Chapter for a chart of updating requirements.

(ii) information the adviser provided in response to Items 4, 8, or 10 of Part 1A or Item 2G of Part 1B becomes materially inaccurate. These items refer to successions, participation or interest in client transactions, control persons, and other business activities; and

(e) the copy of Form ADV Part II that is maintained in an investment adviser's files is considered filed with the SEC. An adviser must update the information in its Part II whenever it becomes materially inaccurate.[42]

1.7 Taking on US clients

1.7.1 Who is a US client?

In counting US clients for purposes of the registration requirement, advisers have traditionally looked to the definition of "US Person" in Regulation S under the US Securities Act of 1933 (the "Securities Act"). Regulation S defines a US person as:

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(a) any natural person resident in the US (which also includes members of "identifiable groups of US citizens abroad", such as members of the armed forces);[43]
(b) any partnership or corporation organised or incorporated under the laws of the US;
(c) any estate of which any executor or administrator is a US person;
(d) any trust of which any trustee is a US person;
(e) any agency or branch of a foreign entity located in the US;
(f) any non-discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary for the benefit or account of a US person;
(g) any discretionary account or similar account (other than an estate or trust) held by a dealer or other fiduciary organised, incorporated, or (if an individual) resident in the US;
(h) any partnership or corporation if organised or incorporated under the laws of any foreign jurisdiction and formed by a US person principally for the purpose of investing in securities not

[42] Rule 204-1(c) under the Advisers Act.
[43] Id at n 1.

registered under the Securities Act, unless it is organised or incorporated, and owned, by "accredited investors" (as defined in Rule 501(a) under the Securities Act) who are not natural persons, estates or trusts.

The following are *not* US persons under Regulation S:

(a) any discretionary account or similar account (other than an estate or trust) held for the benefit or account of a non-US person by a dealer or other fiduciary organised, incorporated, or (if an individual) resident in the US;

(b) any estate of which a professional fiduciary acting as executor or administrator is a US person if:

  (i) an executor or administrator of the estate who is not a US person has sole or shared investment discretion with respect to the assets of the estate; and

  (ii) the estate is governed by foreign law;

(c) any trust of which any professional fiduciary acting as trustee is a US person, if a trustee who is not a US person has sole or shared investment discretion with respect to the trust assets, and no beneficiary of the trust (and no settler if the trust is revocable) is a US person;

(d) an employee benefit plan established and administered in accordance with the law of a country other than the US and customary practices and documentation of such country;

(e) any agency or branch of a US person located outside the US if:

  (i) the agency or branch operates for valid business reasons; and

  (ii) the agency or branch is engaged in the business of insurance or banking and is subject to substantive insurance or banking regulation, respectively, in the jurisdiction where located; and

(f) the International Monetary Fund, the International Bank for Reconstruction and Development, and any other similar international organisations, their agencies affiliates and pension plans.[44]

[44] Rule 902(k) under the Securities Act.

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In a footnote to the release regarding adoption of the hedge fund adviser registration rule, however, the SEC noted that Regulation S is designed for use in transactions, not ongoing advisory relationships, and the use of the Regulation S definition of US Person can raise questions. The SEC stated that until the SEC commissioners reconsider this issue, the SEC staff would not object if advisers looked:

(a) in the case of individuals, to their residence;
(b) in the case of corporations and other business entities, to their principal office and place of business;
(c) in the case of personal trusts and estates, to the rules set out in Regulation S under the Securities Act; and
(d) in the case of discretionary or non-discretionary accounts managed by another investment adviser, to the location of the person for whose benefit the account is held.[45]

Although the hedge fund adviser registration rule subsequently was remanded, this guidance from the SEC remains helpful.

1.7.2 Contracts

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While not legally required, an SEC-registered, non-US adviser should create a standard investment advisory contract to serve as a basis for its negotiations with US clients, and which may differ from those entered into with the adviser's non-US clients (while of course also complying with the adviser's local law and business custom). An unregistered, non-US adviser taking on a US client need not include all of the provisions discussed below, but understanding the requirements and standard practices in a standard US investment advisory contract can, nevertheless, be useful to a non-US investment adviser approaching negotiations with a US client.

The Advisers Act does not explicitly require that all investment advisory contracts must be in writing, and a person may be deemed a "client" of an investment adviser even without a written investment advisory contract. To ensure clarity in the adviser/client relationship (and because the SEC in its inspections generally reviews a sampling

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[45] *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Rel. No. IA-2266 (20 July 2004) at n 126.

of client advisory contracts) it is best practice to execute a written investment advisory contract with each client. This is the case even if the relationship is temporary or "informal".

It is also important to note that a *registered*, non-US adviser, or an unregistered, non-US adviser that chooses to adhere to limited US regulation in its dealings with US clients, may have contractual provisions in its US investment advisory contracts that are distinctly different from those in its advisory contracts with its non-US clients. For example, in a US advisory contract, the adviser cannot "opt out" of best execution. However, because local law and regulation will continue to apply to the relationship, the adviser must continue to include contractual provisions required by such local requirements (such as, in the UK, the additional UK and EU specific disclosure requirements).

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Where an investment advisory contract is contemplated, the Advisers Act requires that it adhere to the following requirements:

(a) *Assignments.* An advisory contract with a *registered* investment adviser must state that the adviser shall not "assign" the contract without client consent.[46] An assignment of an advisory agreement under the Advisers Act includes any direct or indirect transfer of a contract by the adviser, but it also includes the transfer of a controlling block of the adviser's outstanding voting securities by a security holder of the adviser.[47] Since an Advisers Act rule permits assignments that do not result in a change of actual control or management of the investment adviser,[48] the adviser should consider contractually defining "assignment" by reference to the Advisers Act.

(b) *Waiver.* The advisory contract may not purport to bind the client "to waive compliance with any provision" of the Advisers Act or the rules thereunder.[49] To avoid inadvertently violating this law, many advisory contracts include some variation on the following non-waiver disclosure: "Nothing contained herein shall constitute a waiver or limitation of any rights that the client may have under

[46] Section 205(a)(2) of the Advisers Act.
[47] Section 202(a)(1) of the Advisers Act.
[48] Rule 202(a)(1)-1 under the Advisers Act.
[49] Section 215(b) of the Advisers Act.

applicable securities or other laws." This may be a useful clarification if the adviser seeks to limit certain of the client's *contractual* causes of action – in what is known as a "hedge clause" – but not any cause of action for which the Advisers Act or other securities law provides a remedy. The SEC staff has said that whether any particular hedge clause and non-waiver disclosure is permissible under the Advisers Act is a "fact-intensive . . . inquiry" based on "the relationship and communications between a[n adviser] and each [c]lient . . . in light of the form and content of the hedge clause, and the [c]lient's individual circumstances."[50]

(c) *Partnership Changes.* The advisory contract must provide, in substance, that the investment adviser, if a partnership, will notify the client "of any change in the membership of such partnership within a reasonable time after such change,"[51] other than a change in limited partners.[52]

In addition, the following types of provisions, some of which are useful for any investment advisory contract entered into in any jurisdiction, are customarily included in a US investment advisory contract:

- a description of the services to be provided (especially whether services are discretionary or non-discretionary);
- acknowledgement of receipt of Form ADV Part II or the adviser's brochure at least 48 hours prior to execution of the investment advisory contract;
- a set of investment guidelines, showing the investment strategies/approach to be taken and any investment restrictions or limitations required by the client, and a statement as to whether or not such investment restrictions or limitations apply only "at the time of purchase" or if there is a continuing duty to assure that there is no breach of the investment restrictions or limitations;
- the fees to be charged, when they are due and whether they may be debited from the client's account;
- clear and unambiguous indemnification provisions;
- a statement as to whether the investment adviser will vote proxies;

50 *Heitman Capital Management, LLC* (pub avail 12 February 2007).
51 Section 205(a)(3) of the Advisers Act.
52 *Ayco Co LP* (pub avail 14 December 1995).

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- a representation from the client that its relevant governing documents authorise the retention of the investment adviser, along with a certificate of the client's secretary (or equivalent individual) attesting to the incumbency of the officer of the client who executed the investment advisory contract, which will also list persons authorised to give instructions for the client's portfolio, along with sample signatures;
- whether the adviser or the client will be selecting brokers to execute brokerage for the client's portfolio, and, if the client chooses to direct its brokerage, full disclosure with respect to the potential effect of such decision on best execution;
- a statement making it clear that the adviser does not guarantee performance;
- if the account is to engage in futures transactions, the appropriate CFTC legend;[53]
- any requirements necessitated by a client's specific needs, for example, requirements of the US Employee Retirement Income Security Act ("ERISA") that govern pension plans or requirements of the US Investment Company Act of 1940 (the "Investment Company Act") that govern US-registered funds;
- language authorising the investment adviser to aggregate trades with those executed for other accounts;
- some form of delegation clause permitting the adviser to utilise the investment management services of its affiliates;
- language permitting the use of soft dollars (if applicable) and clarifying whether the adviser will be relying on the safe harbour of the US Securities Exchange Act of 1934 (the "Exchange Act");[54] and
- responsibility for incidental expenses such as brokerage fees.

While not customary in such agreements, an adviser might also consider language clarifying whether it intends to monitor class action lawsuits on the client's behalf and/or represent the client in bankruptcy actions or negotiations and lawsuits arising from securities held in the client's portfolio.

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[53] *See infra* Chapter 11.
[54] Section 28(e) of the Exchange Act. *See infra* Chapter 2, Section 2.8.2.

1.7.3 Fees

Fees are determined based upon a number of factors, including the amount of assets under management, the investment objectives and goals of the client, the investment strategies the adviser expects to employ to satisfy such client's investment objectives and goals, the types of assets the adviser expects to acquire and trade for the client's account, the client's tolerance for risk, and any other specific requests made by the client in connection with managing its account. An adviser should be aware of the following:

(a) *Standard fees.* Standard fees of the adviser must be disclosed in the Part II of Form ADV with a statement as to whether they are negotiable;
(b) *Fee limits.* In the US-registered investment fund context, while there is not a specific upper limit on the fees that an adviser may charge, a fee that is "substantially higher than the normal advisory fee paid by investment companies" might violate an adviser's fiduciary duty to a registered investment company under the Investment Company Act.[55] In the unregistered fund or managed account context, charging a fee that exceeds industry norms may be permitted, but failure to disclose to clients and prospective clients that comparable services may be available elsewhere at a lower fee could violate the anti-fraud provisions of the Advisers Act;[56]
(c) *Debiting fees.* If a US-registered adviser or a Participating Affiliate is permitted to debit its fees from the client account, it will be deemed to have "constructive custody" of client assets and must comply with the Advisers Act rule governing custody;[57]
(d) *Dual Fees.* Investing a client's managed account assets into a fund or additional strategy also managed by the adviser, where this has the effect of increasing the adviser's fees, may raise issues, although investing cash in a money market fund also managed by the adviser is permissible where the adviser has reasonable cause to believe the affiliated fund would be at least

[55] Section 36(b) of the Investment Company Act; *Mexico Fund* (pub avail 12 February 1975).
[56] *John C Kinnard & Co, Inc* (pub avail 30 November 1973) ("Kinnard").
[57] Rule 206(4)-2(c)(1)(ii) under the Advisers Act. *See infra* Chapter 2, Section 2.6.

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as good an investment as (1) any other *money market* fund, (2) a *money market* deposit account at a bank, (3) a *money market* instrument, or (4) any other suitable short-term investment.[58] The SEC has also permitted a client's managed account assets to be invested in a non-money market fund managed by the adviser or an affiliate when it could be demonstrated that the dual fees pertained to services provided in different capacities and did not create any special conflicts of interest, and provided further that the adviser obtained the client's consent to the transaction and disclosed the arrangement in writing;[59]

(e) *Performance Fees.* A registered adviser may charge performance fees only to its non-US clients,[60] "qualified purchasers",[61] knowledgeable employees, or certain other sophisticated persons known as "qualified clients."[62] The investment adviser should obtain appropriate representations from the client as to the client's status as a qualified client. The Advisers Act defines a "qualified client" as:

   (i) a natural person who or a company that immediately after entering into the contract has at least $750,000 under the management of the investment adviser;
   (ii) a natural person who or a company that the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:

      (A) has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than $1,500,000 at the time the contract is entered into; or
      (B) is a qualified purchaser as defined in Section 2(a)(51)(A) of the Investment Company Act at the time the contract is entered into; or

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[58] *EF Hutton & Co, Inc* (pub avail 17 November 1983).
[59] *See Neuberger & Berman* (pub avail 30 March 1987).
[60] Section 205(b)(5) of the Advisers Act.
[61] Section 205(a) of the Advisers Act. A "qualified purchaser" is a sophisticated investor qualified to invest in commingled funds exempt from US registration. Section 2(a)(51)(A) of the Investment Company Act. *See infra* Chapter 13, Section 13.3.2.2.
[62] Rule 205-3(a) under the Advisers Act. This provision does not apply to unregistered advisers. Section 205(a) of the Advisers Act.

(iii) a natural person who immediately prior to entering into the contract is:

(A) an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or

(B) an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company, for at least 12 months.[63]

(f) *Termination Fees*. Generally speaking, termination fees (or penalties) are not permissible if their sole or primary purpose is to cause the client not to fire the investment adviser.[64] However, liquidated damages are permissible in order to reimburse the adviser for efforts already undertaken or fees earned but not vested.[65]

1.7.4 Disclosure of conflicts of interest

The SEC and the US courts have interpreted the provisions of Sections 206(1) and (2) of the Advisers Act broadly to require an investment adviser to disclose all material facts, especially conflicts or potential conflicts of interest in which the investment adviser's interests may not be aligned with those of its clients.[66] While the

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[63] Rule 205-3(d)(1) under the Advisers Act.

[64] *National Deferred Compensation, Inc* (pub avail 31 August 1987) ("an adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser's service or if it imposes an additional fee on a client for choosing to change his investment").

[65] *See Constellation Financial Management, LLC* (pub avail 9 January 2003); *Stephenson and Co* (pub avail 29 December 1980).

[66] Release No 1092, *supra* fn 2, at n 20–21 (citing *SEC* v *Capital Gains Research Bureau*, 375 US 180, 200 (1963)).

Investment Company Act (which pertains to US-registered investment companies) was designed to *eliminate* many types of conflicts of interest in the retail investment realm, the Advisers Act was more generally designed to ensure that conflicts of interest are *disclosed* to clients and prospective clients in order to give them the choice whether to hire the investment adviser or to take steps to protect themselves.

Of course, while an investment adviser may effect transactions in which the adviser has a personal interest if appropriate disclosure has been made to the clients, nevertheless, the adviser must act at all times in the client's best interest and may not effect transactions that benefit the adviser to the detriment of the client, even where full disclosure of the conflict has been made to the client or potential client.[67] In other words, full disclosure of a conflict of interest should not be viewed by an adviser as enabling an adviser to self-deal. Importantly, no matter how much disclosure of a material conflict of interest is made by an adviser to the adviser's clients and potential clients, it is possible that the SEC and its staff may view the disclosures made as inadequate and, therefore, any client consent based on such disclosure as inappropriate.

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In addition, it is important for a non-US adviser to understand that the disclosure requirements in the adviser's local jurisdiction may differ significantly from those enumerated by the SEC and to pay close attention to the US requirements (while of course continuing to provide all clients, including the adviser's US clients, with the disclosure required by the adviser's local regulations). With respect to disclosure, an investment adviser has the duty:

(a) to disclose the various capacities in which the adviser might act when dealing with any particular client, for example, in dealing with affiliated broker-dealers for the client's account,[68] including any compensation the investment adviser would receive from the broker-dealer in connection with a transaction;

[67] Release No 1092, *supra* fn 2 at n 27, citing *Kidder, Peabody & Co, Inc,* 43 SEC 911, 916 (1968).
[68] Id at n 22 (citing *In the Matter of Haight & Co, Inc,* Exchange Act Rel No 9082 (19 February 1971)).

(b) if utilising an affiliated broker-dealer, to disclose the client's ability to execute recommended transactions through other brokers or dealers;[69]
(c) if the adviser is employed by a broker-dealer, to disclose whether the adviser's advisory activities are independent from the adviser's employment with the broker-dealer;[70]
(d) if the adviser will recommend or use *only* the financial products offered by the adviser's employer when implementing financial plans for the adviser's clients, to disclose this practice to all clients and inform clients that the plan may be limited by the products offered by the adviser's employer;[71]
(e) if the adviser or its personnel structure their personal securities transactions to trade on the market impact caused by their recommendations to clients, to disclose this practice to clients;[72]
(f) to disclose whether the adviser's personal securities transactions are or might be inconsistent with the advice given to clients;[73]
(g) to disclose any compensation received from the issuer of a security being recommended;[74] and
(h) if charging a fee that exceeds industry norms, to disclose to clients and prospective clients that comparable services may be available elsewhere at a lower fee.[75]

These disclosures may be made generally in the adviser's Form ADV Part II or brochure, or in the investment management agreement (or, with respect to advisers to unregistered investment funds, in the fund's offering document). Depending on the seriousness of the conflict disclosed, the adviser might consider providing separate written disclosure regarding the conflict.

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69 Id at n 25 (citing *Don P Matheson* (pub avail 1 September 1976)).
70 Id at n 23 (citing *David P Atkinson* (pub avail 1 August 1977)).
71 Id at n 26 (citing *Elmer D Robinson* (pub avail 6 January 1986)).
72 Id at n 28 (citing *SEC* v *Capital Gains Research Bureau*, 375 US 180, 197 (1963)).
73 Id at n 29 (citing *In the Matter of Dow Theory Letters et al.*, IA Rel No 571 (22 February 1977)).
74 Id at n 30 (citing *In the Matter of Investment Controlled Research et al*, IA Rel No 701 (17 September 1979)).
75 *Kinnard*, *supra* fn 56.