Private Fund Advisers

January 13, 2025

COMPLIGLOBE
THE WORLD'S REGULATORY ADVISER™

What is an “investment adviser”?

- Under the U.S. Investment Advisers Act of 1940, an investment adviser is any person that

  1. for compensation
  2. is engaged in the business of providing investment advice about securities or investments
  3. to others

- If a non-U.S. person does this using the “means of interstate commerce” (post, fax, e-mail, visit, text, instant messaging, social media, phone or web site), it becomes amenable to the SEC’s jurisdiction and must satisfy an exemption or register with the SEC, or cease the activity

“Managing assets” and “investment advice”

- Investment advice
  - Exercising discretion
  - Being a non-discretionary adviser and giving/providing research, advice or recommendations (excludes taking orders to buy or sell securities)
- To others
  - Private funds
  - Separately managed accounts (“SMA”)

- Being the adviser to a private fund
  - Includes a sub-adviser to the adviser
  - Includes an AIFM
  - Includes the general partner of a private fund that receives investment advice or recommendations from the AIFM or the adviser and makes the investment decision

Who is a "U.S. person"?

- This definition is based on *residence,* as defined in Regulation S under the U.S. Securities Act of 1933
  - Individuals: where they *reside*
  - Partnership or corporation
    - If not organized in a U.S. state, it is not a U.S. person - *however*
    - It *would* be a U.S. person if it was (i) organized or incorporated under the laws of any foreign jurisdiction and (ii) formed by a U.S. person principally for the purpose of investing in securities not registered under the U.S. Securities Act, unless it was organized or incorporated, and owned, by accredited investors (as defined in Regulation S who are not natural persons, estates or trusts
  - Trusts, estates, etc: the location of trustees, executors
  - Investment managers: where its clients reside

The definition of U.S. person in the context of the Private Fund Adviser exemption

- Release IA-3222 – Private Fund Adviser exemption adopting release
  - "A client will not be considered a United States person if the client was not a United States person at the time of becoming a client of the adviser."
  - "This will permit a non-U.S. adviser to continue to rely on rule 203(m)–1 if a non-U.S. client that is not a private fund, such as a natural person client residing abroad, relocates to the United States or otherwise becomes a United States person."
- Rule 203(m)-1(D)(8)
  - carve out from the definition of U.S. person for purposes of this exemption: The rule also provides that "any discretionary account or similar account that is held for the benefit of a United States person by a dealer or other professional fiduciary is a United States person if the dealer or professional fiduciary is a related person of the investment adviser relying on this section and is not organized, incorporated, or (if an individual) resident in the United States."
  - Note to this provides that "A client will not be considered a United States person if the client was not a United States person at the time of becoming a client."

- Advisers Act Section 208(d): unlawful to do something indirectly that one cannot do directly

What is a “private fund”?

A company, LLC, partnership, LLP, unit trust or other legal vehicle (not a SMA) that is not an investment company for purposes of the U.S. Investment Company Act of 1940 because it

- does not have more than 100 U.S. person beneficial owners – the Section 3(c)(1) exemption (*rarely used*)

- has only U.S. persons that are “qualified purchasers” (never more than 499 in any one fund) – the Section 3(c)(7) exemption

Regulatory assets under management – "RAUM"

- Includes *all* securities portfolios subject to continuous and regular management, including
  - proprietary assets
  - assets managed for no compensation
  - assets of non-U.S. clients
- In the case of a private fund, includes
  - uncalled capital commitments
  - leveraged assets
  - all assets, regardless of the type of assets held by that fund
- Sub-adviser must include only assets over which it actually provides advisory services
- Include all gross assets without any deductions for debt or leverage
- Value private fund assets at fair value

Non-U.S. firms and the U.S. markets

1. No involvement with the United States?
   - No need to register as an investment adviser with the SEC under the Advisers Act ("RIA") or to use the Foreign Private Adviser or the Private Fund Adviser exemptions
2. Manage U.S. money directly (in SMAs) and *not* via a private fund
   - Satisfy the Foreign Private Adviser exemption or become an RIA
3. Manage U.S. money *only* in one or more private funds
   - If the total US$ RAUM from all U.S. persons is less than US$25m and there are not more than a total of 14 U.S. persons, remain a Foreign Private Adviser, no need to become an RIA or a Private Fund Adviser
   - If the total US$ RAUM from all U.S. persons is greater than US$25m or there are 15 or more U.S. persons in the private funds, (a) use the Private Fund Adviser exemption and file a Report on Form ADV Part 1 with the SEC and be an Exempt Reporting Adviser, "ERA", or (b) become an RIA
4. Manage U.S. money directly *and also* in a private fund
   - If you have 15 or more U.S. clients (direct in SMAs or in private funds) *or* more than US$25m from any or all of these clients, you must become an RIA

Exemption: "Foreign Private Adviser"

1. No place of business in the United States;
   - Avoid U.S. activity, directly or indirectly
2. Fewer than 15 U.S. persons (SMAs) *and* U.S. persons in a private fund;
   - Add both – direct and indirect U.S. resident clients
3. Aggregate RAUM of less than US$25m attributable to direct and indirect U.S. clients in #2 above;
4. Does not hold itself out in the United States as an adviser; *and*
   - *Be careful with press releases, articles, conferences, visits and events*
5. Does not advise U.S. registered investment companies ("RICs") or U.S. registered business development companies

Exemption: "Private Fund Adviser"

1. An adviser only to private funds *and*

2. Aggregate RAUM of no more than US$150m, determined annually

   - U.S. based advisers managing private fund assets from a location *in* the United States count all private fund assets towards the US$150m cap
   - For firms based outside the United States and managing private fund assets from a non-U.S. location, the US$150m cap does not apply
   - Non-U.S. firms must run both the Foreign Private Adviser and Private Fund Adviser exemption tests together, so that if you have more than 15 U.S. person investors in the private funds you advise or RAUM of more than US$25m from these investors, become a Private Fund Adviser to avoid full registration

Implications

If a non-U.S. person uses the means of interstate commerce to provide investment advice to a U.S. person, it has these choices

- Cease the activity – *no contact with any U.S. persons, no marketing in the United States and do not set up an office in the United States*
- Stay under the US$25m and 15 U.S. person caps and be a Foreign Private Adviser – *limited contact (do not set up an office in the United States)*
- Become a Private Fund Adviser and take U.S. person funds only via a private fund – *limited contact (do not take U.S. person money in a separately managed account)*
- Become an RIA – *full contact with U.S. persons*

Do not forget

- *If the non-U.S. adviser manages U.S. person assets directly, it cannot be a Private Fund Adviser*
- *Always apply the Foreign Private Adviser and Private Fund Adviser exemptions at the same time*

ERAs

- They are exempt from Advisers Act registration and have these requirements
  - File Form ADV 1 (and pay a filing fee) to disclose *publicly*
    - "core" identifying information
    - US$ RAUM
    - affiliations - "related persons"
    - private fund information
    - disciplinary history
    - direct and indirect owners
    - officers and directors/partners
    - additional information in the Schedule D Miscellaneous box
  - Keep Form ADV Part 1 disclosures materially correct and current
- Report on Form ADV Part 1 becomes effective upon filing
- Subject to a "for cause" examination (evidence of violations of U.S. federal securities laws)
- Liable for failure to supervise and breach of the antifraud rules
- Must have "pay to play" controls

Failure to supervise

- Under Advisers Act Section 203(e)(6), must supervise with a view to *preventing* violations of the U.S. federal securities laws
- A violation of the Advisers Act and the rules thereunder may also be a failure to supervise
- What you must do
  - Implement and policies and procedures reasonably designed to prevent (or detect and address) violations of the Advisers Act and the rules
  - Implement and policies and procedures reasonably designed to supervise with a view to prevent (or detect and address) violations of law
  - Keep evidence to prove that the supervisor in question reasonably discharged their duties and obligations under such procedures without reasonable cause to believe they were not being complied with

Rule 206(4)-8

- Protects the interests of investors and prospects with respect to *pooled investment vehicles* – with respect to ERAs, includes private funds
- Applies to every *adviser* to a pooled investment vehicle – includes RIAs and ERAs
- The rule makes it unlawful for an RIA or ERA to make a materially false or misleading statement, engage in a fraudulent act or make a material misstatement or omission in a private placement memoranda, side letter, slide deck, oral statement, DDQ or RFP
- Negligence arising from a breach of fiduciary duty would suffice for liability
- A statement, omission or act is measured on the basis of materiality – information is "material" if a reasonable investor would consider it significant and it would alter the mix of information publicly available
  - Materials must be cleared to ensure that they are materially correct with no material omissions
  - Care should be taken in conversations to state facts clearly and correctly
- Only the SEC can bring an action – private investors cannot sue under this rule but would use the antifraud provisions of Exchange Act Section 10(b) or Rule 10b-5

Other U.S. regulatory disclosure obligations

- Beneficially owning more than 5% of a class of equity security registered with the SEC under Section 12 of the Exchange Act?
  - Those exercising control file Schedule 13D – individually or as part of a group
  - Those not exercising control file Schedule 13G
  - Broad definition of a "group" for purposes of filing a Schedule D
- Beneficially owning more than 10% of a class of equity security registered with the SEC under Section 12 of the Exchange Act
  - File reports under Section 16(a)
  - Subject to short swing profit liability under Section 16(b)
- Manage more than $100m in U.S. listed securities – must file Form 13F
- Large trader reporting on Form 13H

Reporting requirements

Annual Updating Amendments

- You must amend your Form ADV each year by filing an annual updating amendment within 90 days after the end of your fiscal year
- When you submit your annual updating amendment, you must update your responses to all required items, Part 1A: 1, 2, 3, 6, 7, 10, and 11, including Schedules A, B and D

Other-than-Annual Amendments

- You must amend your Form ADV by filing additional amendments promptly if
  - information provided in response to Items 1, 3, 6, 7 or 11, or a Schedule, becomes inaccurate in any way
  - information provided in response to Item 10 becomes materially inaccurate

“Pay to play”: Rule 206(4)-5

- Designed to prevent political contributions from affecting the selection of adviser or fund
- Applies to non-U.S. advisers (registered or required to be registered) and ERAs that provide or seek to advise U.S. state or municipal governments, including pension plans
- Includes advice through a pooled investment vehicle
- Three elements
  - Two-year time out after contribution
  - Ban on use of a solicitor or “placement agent” that is not a “regulated person” – basically, an SEC registered broker
  - Prohibits “bundling” of contributions

SEC examinations

- The SEC has examination authority over ERAs
- ERAs are subject to a “for cause” examination by the SEC - when there is evidence of wrongdoing
- Examinations may include interviews of staff in various functions and at various levels of seniority

On-going tasks

- Employ means reasonably designed to ensure the following
  - Form ADV Part 1 disclosure is materially correct
  - Proper activity – to avoid violating the antifraud provisions of the Advisers Act and, as applicable, other U.S. federal securities laws
  - Proper supervision
  - Compliance with “pay to play” requirements
  - Record keeping to support disclosures
  - Not losing the exemption
  - Not violating the antifraud provisions
- May use local country requirements to help achieve these

How to “lose” Private Fund Adviser status

- If you accept a U.S. person client mandate directly (separately managed account)
- If you have a person, branch or subsidiary in the United States and it is involved in managing assets of more than US$150m

CompliGlobe Ltd

CompliGlobe (Asia) Ltd

Mark Berman

berman@compliglobe.com

Lisa Byington

byington@compliglobe.com

London + 44 208 458 0152

Hong Kong + 852 8124 5181

www.compliglobe.com

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