A U.S. Regulatory Roadmap for Non-U.S. firms

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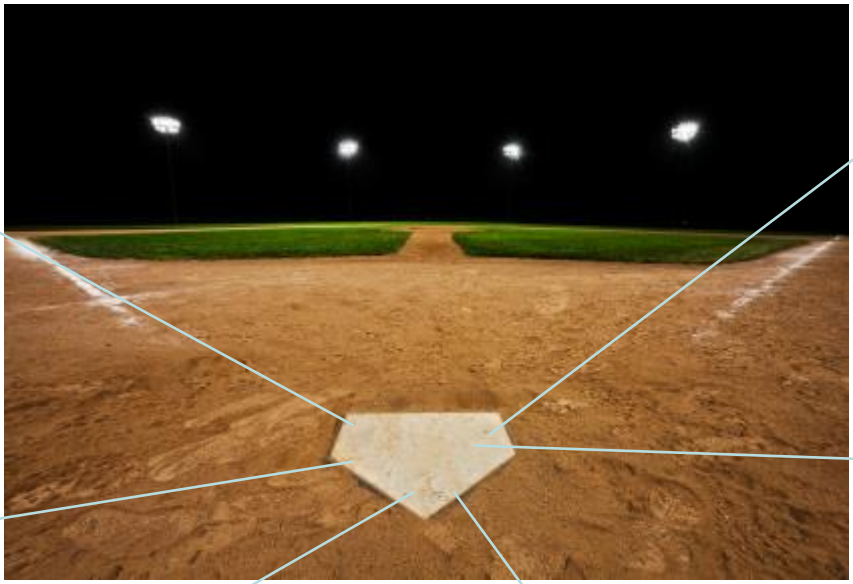
Cover all the bases …

For a non-U.S. fund: register or exempt the securities from SEC registration under the Securities Act of 1933



Register or exempt the adviser from SEC registration under the Investment Advisers Act of 1940

Register or exempt the seller of the securities as a BD under the Securities Exchange Act of 1934

Exempt the non-U.S. fund from being an investment company under the Investment Company Act of 1940

Do you want to be a CTA or CPO: Commodity Exchange Act

Do not forget: FCPA, FATCA and Internal Revenue Code (tax) issues

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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
  3. providing investment advice about securities or investments to others

- Must satisfy all three elements

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

If you want to manage assets for U.S. persons?

- No involvement with the United States?
  - No need to register as an investment adviser with the SEC under the Advisers Act ("RIA") or file a report to become an Private Fund Adviser
- You want to manage U.S. money directly (segregated account), not via a private fund
  - Satisfy the Foreign Private Adviser exemption or become an RIA
- You want to manage U.S. money *only* in a private fund
  - Use the Private Fund Adviser exemption or become an RIA
- You want to manage U.S. money directly and also in a private fund
  - If you have 15 or more U.S. clients (direct and in a private fund) or more than $25m from any or all of these clients, you must become an RIA

Who is a "U.S. person"?

- The SEC uses the Regulation S definition of "U.S. person", which is based on ***residence***
  - Individuals: where they *reside*
  - Partnerships and companies: where incorporated
  - Trusts, estates, &c: the location of trustees, executors
  - Investment managers: where the clients reside

Release IA-3222 and Rule 203(m)-1 – Private Fund Adviser exemption: "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."

Release IA-3222 and Rule 203(m)-1 – Foreign Private Adviser exemption: "A person who is in the United States may be treated as not being in the United States if such person was not in the United States at the time of becoming a client or, in the case of an investor in a private fund, each time the investor acquires securities issued by the fund."

What is a “private fund”?

A company, LLC, partnership, LLP, unit trust or other legal vehicle 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

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

Exemption: "Foreign Private Adviser"

1. No place of business in the United States;
   - Avoid doing anything on a regular basis in the United States
2. Fewer than 15 U.S. clients (direct mandates) *and* U.S. investors in a private fund;
   - Add both – direct and indirect U.S. resident clients
3. Aggregate "regulatory assets under management" ("RAUM") of less than $25m attributable to the 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 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

   – U.S. resident clients invest in the funds and do not give the adviser money to manage directly

2. Aggregate RAUM of no more than US$150m, determined annually – count only assets managed from a location in the United States

   – You're outside the United States, so the $150m cap does not apply

- Non-US adviser may only count U.S. persons and aggregate assets managed at a place of business in the United States

  – Run both the Foreign Private Adviser and Private Fund Adviser tests together so that if you have more than 15 U.S. client investors in a fund with more than $25m, become a Private Fund Adviser to avoid full registration

- You become an "Exempt Reporting Adviser", report on Form ADV Part 1 and may be subject to a "for cause" exam

“Regulatory assets under management”

- 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:
  - Uncalled capital commitments of a private fund
  - 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

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:

1.Cease the activity – *no contact*

2.Stay under the US$ 25m and 15 U.S. person caps and be a Foreign Private Adviser – *very limited contact*

3.Become a Private Fund Adviser and take U.S. person funds only via a private fund – *limited contact*

4.Become an RIA – *full contact*

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*

What is a “broker”?

- The term “broker” is defined in Section 3(a)(4) of the U.S. Securities Exchange Act of 1934 as a person who effects transactions in securities for the account of others

- If a non-U.S. person uses the means of interstate commerce to
  - solicit and/or effect transactions in securities for the account of others
  - receive transaction-based compensation, directly or indirectly
  - hold itself out as such (e.g. directly or by being amenable …)

  it would be a “broker” and, absent an exception, exemption, rule or no-action letter, must (1) cease the activity, (2) use an SEC registered broker-dealer or (3) register as a broker-dealer with the SEC

- Covers … trading, M&A activities, soliciting the purchase or sale of the securities of a private fund

"To qualify as a broker, the activities of the alleged broker must be characterized by a certain regularity of participation in securities transactions at key points in the chain of distribution" and be "engaged in the business" of securities transactions".

SEC v. Zubkis, No. 97 Civ. 8086, 2000 WL 218393, (S.D.N.Y. Feb. 23, 2000); *accord SEC v. Hansen*, No. 83 Civ., 3692, 1984 WL 2413 (S.D.N.Y. Apr. 6, 1984), *Massachusetts Financial Services, Inc. v. SIPC*, 411 F.Supp. 411, 415 (D. Mass. 1976), *aff'd* 545 F.2d 754 (1st Cir. 1976), *cert. denied* 431 U.S. 904 (1977); *MuniAuction, Inc*., SEC No-Action Letter, 2000 WL 291007 (March 13, 2000). *See also Massachusetts Financial Services, Inc. v. SIPC.*, 411 F. Supp. 411 (D. Mass. 1976).

What does this mean for a non-U.S. firm?

- Are we dealing with “securities” under the U.S. federal securities? If yes,
- Am I holding myself out, taking orders, soliciting U.S. client orders to buy the securities of a private fund, soliciting brokerage, or receiving unsolicited orders to buy or sell securities? If yes,
- Are the means of interstate commerce involved? If yes,
- Does the Exchange Act give me an “exception”? If no,
- Does a rule apply (Rule 15a-6 or Rule 3a4-1) or a “safe harbour”? If no,
- Is there a relevant interpretation or would a Rule 15a-6 FAQ cover me? If no,
- Has the SEC given me an exemption (derogation)? If no,
- Is there a no-action letter on point? If no,

1. register with the SEC as a broker
2. use an SEC registered broker-dealer
3. do not engage in this activity!

Relevant SEC Staff no-action letters

Adviser that transmits orders to brokers/banks for execution, does not hold client funds or securities, does not solicit a client for an order, does not send the client research with the purpose of receiving an order *and* does not receive transaction-based compensation for these activities is not required to register with the SEC as a broker-dealer

- *This posits no client involvement in the process of effecting a transaction – from research through formation of advice or recommendation to placing the order, execution and matching, clearing and settlement*
- See *First Atlantic Advisory Corp*. (20 February 1974), *McGovern Advisory Group, Inc*. (7 August 1984) and *In Touch Global LLC* (14 November 1995)

No-action relief denied where the adviser's activities were more extensive e.g. soliciting brokerage or sending research

- *This posits client-facing involvement designed to obtain, receive or effect an order to buy or sell securities*
- See e.g. *PRA Securities Advisers LP* (3 March 1993)

Exemption from BD registration: Rule 15a-6

- Exemption from Exchange Act broker-dealer registration for non-U.S. entities that would be a "broker" or "dealer" and that engage in certain activities with U.S. investors using the means of interstate commerce
- Rule 15a-6 permits (subject to compliance with its conditions)
  - Sending research to and soliciting *major U.S. institutional investors*
  - Soliciting and executing trades with or for *U.S. institutional investors* - restrictions on calling, visiting and sending research
  - Executing *un*solicited transactions with U.S. persons – hard to establish and, despite the Rule 15a-6 SEC Staff *FAQs* permitting "more than one" such transaction, not possible for expanded brokerage activities or solicitations
  - Engaging in "principal to principal" trades directly with registered broker-dealers and certain other enumerated entities
- Generally, Rule 15a-6 is not available when dealing with individuals – only the two enumerated types of institutions
- A U.S. person cannot rely upon Rule 15a-6

Key definitions for Rule 15a-6

- *Solicitation:* coined in 1989 when the SEC adopted Rule 15a-6 and given it a broad meaning -- even a single act to open an account or encourage a person to buy or sell a security is a solicitation. This remains in place today. *See* "Registration Requirements for Foreign Broker-Dealers", Exchange Act Release 27017, 54 FR 30013 (13 July 1989)
- *Major U.S. institutional investor*: an entity that owns, controls or has under management more than $100m in aggregate financial assets
- *U.S. institutional investor*: RIC; a bank, savings and loan association, insurance company, business development company, small business investment company or employee benefit plan defined in Securities Act Regulation D Rule 501(a)(1); a private business development company defined in Rule 501(a)(2) of Regulation D; an organisation described in Section 501(c)(3) of the U.S. Internal Revenue Code of 1986; or a trust defined in Rule 501(a)(7) of Regulation D

Rule 15a-6 FAQs

- Question 9 of Rule 15a-6 FAQs treats when a few more than one *bona fide* unsolicited transaction exemption *for the same U.S. investor* would attract SEC scrutiny
- Paraphrasing FAQ 9, the SEC Staff stated that it would not ordinarily consider one transaction in compliance with Rule 15a-6(a)(1) as preventing more than one such transaction, but caveated this as being evident of a solicitation. Noting, the SEC Staff continued, that solicitation is broadly interpreted, it cited factors from the 1989 Rule 15a-6 Adopting Release that would be evident of a solicitation:
  - calls from a firm to a client encouraging use of the firm to effect transactions
  - advertising directed into the United States of one's function in this respect
  - recommending the purchase or sale of particular securities, with the anticipation that the client would execute the recommended trade through the firm

- E-mails, blotter entries, visit records and other firm records would be used, forensically, to establish a pattern of solicitation or receiving “unsolicited” orders

FAQ 9 cont'd

- Continuing, the SEC Staff stated that "a series of frequent transactions or a significant number of transactions between a foreign broker-dealer and a U.S. investor as being indicative of solicitation through the establishment of an "ongoing securities business relationship"
- Thus, and because non-U.S. firms that were not registered as a broker could not provide the protections that an SEC registered broker-dealer could, engaging in a few more than one unsolicited transaction carries with it significant risks
- FAQ 9 refers to "the same U.S. investor". It does not address two or more U.S. investors of a foreign firm. As such, non-U.S. firms would be advised not to try to apply FAQ 9 to more than one of their U.S. clients at the risk of being deemed to be an unregistered broker, outside the parameters of Rule 15a-6(a)(1) and in violation of the Exchange Act's broker-dealer registration requirements

Selling the securities of a private fund

- In IA Release 3222 (2011) adopting new exemptions from Advisers Act registration, the SEC stated that “persons who market interests in a private fund may be subject to the registration requirements of section 15(a) under the [Exchange Act]" and that ‘‘[s]olicitation is one of the most relevant factors in determining whether a person is effecting transactions”
- This was issued by the Commission itself, not the Staff
- It dealt with solicitation and was silent on transaction-based compensation
- It was given in the context of marketing the securities of private funds, but was silent on whether it applies in other contexts – such as the solicitation of brokerage, direct or indirect, or a client giving an adviser an order
- Non-U.S. firms should proceed on basis that this Commission interpretation may “trump” Staff no-action letters on brokerage and that solicitation by itself might be enough to kick-off the broker-dealer registration requirements - enforcement actions will “clear the way”

“Issuer’s exemption”: Exchange Act Rule 3a4-1

- Extremely narrow, limited safe harbour
- For issuers that propose to market their securities by an “associated person”
- The associated person
  - cannot be subject to a statutory disqualification
  - must have other significant duties apart from marketing
  - cannot receive commissions or other transaction-based compensation
  - cannot be an associated person with a broker or dealer at the time of the sale
- Associated persons are partners, officers, directors and employees of the issuer, the GP of a partnership of an LLP or the MD of an LLC
  - only associated persons may engage in such marketing
  - the associated person must have other substantial duties apart from marketing
  - limited class of institutional investors
  - one offering per 12 month period
- Passive sales activities – written communications or delivering PPM, responding to queries and ministerial or clerical work

“Rules of the road” for Rule 3a4-1

- Satisfy the requirements of this rule (as above)
- Keep detailed records
- Do not do indirectly something that you could not do directly
- Do not engage in a discussion of specific fund performance
- Statements must be 100% correct. Correct mistakes on the spot. Remember that the antifraud provisions of the U.S. federal securities laws apply
- Avoid communications with the media
- Be aware of and demonstrate compliance with the prohibition on “general solicitation” in Regulation D under the U.S. Securities Act of 1933 (your fund will if sold in the United States, probably use Regulation D)
- Ensure the fund is exempt from being an investment company under Sections 3(c)(1) or 3(c)(7) of the 1940 Act

Non-U.S. adviser solicits U.S. prospect to buy the securities of a non-U.S. private fund

- Under the IA-3222 interpretation, this would be brokerage
- Options:
  - if available, rely upon Rule 3a4-1
  - use Rule 15a-6 for “major U.S. institutional investors” – still requires an SEC registered broker-dealer to intermediate trades
  - get an SEC registered broker to chaperone (issue research and intermediate the trade) for “U.S. institutional investors”
  - have an SEC registered broker-dealer handle the transaction entirely for all other persons
  - register as a broker
  - avoid the U.S. markets

SEC sues four India-based brokers – November 2012

- The SEC sued four India-based brokers for engaging in brokerage with U.S. residents and not registering with the SEC as a broker, or not using Rule 15a-6

  SEC Order: Ambit Capital Pvt. Ltd.

  SEC Order: Motilal Oswal Securities Limited

  SEC Order: JM Financial Institutional Securities Private Limited

  SEC Order: Edelweiss Financial Services Limited
- Key SEC finding:
  - "Sponsored conferences in the U.S.
  - Had employees travel regularly to the U.S. to meet with investors.
  - Traded securities of India-based issuers on behalf of U.S. investors
  - Participated in securities offerings from India-based issuers to U.S. investors."
- Solicitation played a key role in these cases

SEC v Credit Suisse (2014)

- In February 2014, the SEC sued Credit Suisse Group AG for, *inter alia*, soliciting cross border brokerage (and investment advisory services) without being registered with the SEC as a broker-dealer and an investment adviser. The SEC alleged that this involved as many as 8,500 accounts, more than 100 trips to the United States to meet clients. It was also noted that while Credit Suisse did implement controls to prevent such violations (after the *UBS AG* enforcement action), it took several years before the activities ceased and Credit Suisse ceased to collect fees

In the Matter of Credit Suisse Group AG, Admin Proc 3-15763 (21 February 2014), http://www.sec.gov/litigation/admin/2014/34-71593.pdf

In the Matter of HSBC Private Bank (Suisse) SA - 2014

- The SEC sued HSBC for, *inter alia*
  - visiting and soliciting hundreds of U.S. residents to effect transactions in securities and not registering as a broker-dealer *and*
  - visiting and giving investment advice to thousands of U.S. residents and not registering as an investment adviser
  - failing to register despite express knowledge of requirements
- HSBC admitted its wrongdoing and consented to (1) a censure (2) cease-and-desist from further violations of U.S. law and (3) payment of $12.5m in disgorgement

In the Matter of HSBC Private Bank (Suisse), SA, Admin Proc 3-16288 (25 November 2014), www.sec.gov/litigation/admin/2014/34-73681.pdf

Finders

- Finders or solicitors must be registered as a broker with the SEC
- Be aware of the *Ranieri* case (March 2013) and its implications
  - A consultant solicited investors for a fund and was paid fees for this, but never registered with the SEC as a broker
  - It was argued that the consultant did no more than make initial introductions
  - According to the SEC, the consultant went "far beyond" that

  "[the finder] sent private placement memoranda, subscription documents, and due diligence materials to potential investors, and urged at least one investor to consider adjusting portfolio allocations to accommodate an investment with [the adviser]. [The finder] provided potential investors with his analysis of the strategy and performance track record for [the funds], and also provided confidential information identifying other investors and their capital commitments."

William M. Stephens, http://www.sec.gov/litigation/admin/2013/34-69090.pdf

Ranieri Partners LLC and Donald W. Phillips, http://www.sec.gov/litigation/admin/2013/34-69091.pdf

Final thoughts

- The SEC and the SEC Staff under delegated authority, not counsel, has the final say on what is or is not brokerage
- According to the SEC Staff, the precedents in this area are well settled and unlikely to change in the foreseeable future
- The SEC Staff has cautioned not to look for safe harbours where there are none

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