

Should you stay or go? Private fund adviser registration after Goldstein

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Abstract

Purpose – To discuss factors that a private fund advisor should consider in its decision to remain registered with Securities and Exchange Commission (SEC) or to deregister in light of the D.C. Court of Appeals June 2006 decision in *Goldstein v. Securities and Exchange Commission*.

Design/methodology/approach – Analyzes and compares the advantages and disadvantages of staying registered and deregistering; discusses the requirements of state registration for advisers that are not registered with the SEC; and analyzes the consequences to private fund advisors if the SEC does not repropose certain rule amendments adopted along with Rule 203(b)(3)-2 concerning bookkeeping, performance fees, and custody.

Findings – Advisers should carefully consider their facts and circumstances and their business plans when analyzing the consequences of deregistration with the SEC – most importantly, the possibility of multiple state registration – before filing to deregister. Especially if the SEC restores the rule amendments the *Goldstein* decision struck down, staying with the SEC – the regulator you know – may be better than registering with a state.

Originality/value – Provides an up-to-date analysis of factors that private funds should consider concerning SEC registration in light of the recent *Goldstein* decision.

Keywords Fund management, Financial management, Investments

Paper type Technical

The D.C. Court of Appeals' June 2006 decision in *Goldstein v. Securities and Exchange Commission* did more than strike down Advisers Act Rule 203(b)(3)-2, the rule requiring many advisers to private funds to register with the SEC as investment advisers. It also eliminated a number of rule amendments adopted to ease the burdens of regulation for these managers by providing certain grandfathering exemptions. While the SEC has not yet stated whether it will appeal the *Goldstein* decision, Chairman Cox recently stated that the SEC intends to re-propose the rule amendments. Even if the SEC ultimately re-adopts the rule amendments, private fund advisers will have to decide whether to remain voluntarily registered with the SEC or to deregister with the SEC. Advisers who deregister, however, may find themselves subject to state registration and regulation, and may decide the wiser choice is to remain with the SEC.

State registration: a trap for the unwary

In the wake of the *Goldstein* decision, many private fund investment advisers that recently registered with the SEC are now considering the costs and benefits of their federally registered status, especially in those states that would require these advisers to register if they are not "federally covered" advisers. For many, the most significant benefit of remaining registered with the SEC may be the ability to escape multiple and conflicting state regulation, which can be difficult to interpret and is subject to change, in favor of the relative certainty of SEC regulation.

In October 1996, Congress enacted the National Securities Markets Improvement Act of 1996 (“NSMIA”), which was intended, in part, to address the states’ lack of uniform securities regulation and to realign the regulatory responsibilities between federal and state securities regulators. NSMIA significantly preempted state-imposed securities registration requirements, while preserving the states’ right to investigate and prosecute securities fraud. In particular, Section 203A(b) of the Investment Advisers Act of 1940, as amended (the “Advisers Act”) precludes states from imposing investment adviser registration requirements on federally registered investment advisers. NSMIA thus relieves federally registered investment advisers from the task of interpreting and complying with myriad state adviser registration requirements.

Section 222(d) of the Advisers Act also precludes states from imposing investment adviser registration requirements on an adviser that:

- does not have a place of business located in within the state; and
- during the preceding 12-month period, has had fewer than six clients who are residents of that state.

Put another way, states can require the registration of an investment adviser that is not registered with the SEC, and has either a place of business in the state or six or more clients who are residents of that state.

A brief overview of the blue sky laws and rules of Massachusetts, Connecticut, California and New York demonstrates some of the issues that private fund advisers should analyze before deregistering with the SEC.

Massachusetts and Connecticut require an investment adviser to register with the state if it either has a place of business within the state, or advises five^[1] or more state residents^[2]. Conversely, Massachusetts and Connecticut exempt an investment adviser from registering if it does not have a place of business in the state and had fewer than five^[3] clients who were state residents during the preceding 12 month period. For purposes of counting the number of clients in Massachusetts, the following entities are excluded: “federal covered advisers, other investment advisers, broker-dealers, banks, savings institutions, trust companies, insurance companies, investment companies as defined in the Investment Company Act of 1940, employee benefit plans with assets of not less than \$5,000,000, governmental agencies or instrumentalities, or other financial institutions or institutional buyers, whether acting for themselves or as trustees with investment control^[4].” Connecticut’s Uniform Securities Act does not define “client” or exclude certain institutions as “clients.” As a result, it is not clear if Connecticut would count both retail and institutional clients when determining whether an adviser must register.

Similarly, California requires an investment adviser to register with the state if the adviser has six or more clients who are residents of California or a place of business in the state. California has defined “client” to exclude other investment advisers, broker-dealers, banks, savings and loan associations, trust companies, insurance companies, investment companies registered under the Investment Company Act of 1940, pension and profit-sharing trusts (other than self-employed individual retirement plans), or other institutional investors or governmental agencies or instrumentalities designated by rule or order of the commissioner^[5].

However, California also exempts from registration an investment adviser that:

- does not hold itself out publicly as an investment adviser;
- has fewer than 15 clients;
- is exempt from registration under the Advisers Act; and
- either has assets under management of not less than \$25,000,000, or advises only venture capital companies^[6].

In other words, if an investment adviser does not hold itself out as an investment adviser and has \$25,000,000 in assets under management, it may have up to 14 clients without registering as an investment adviser with the State of California.

While the Massachusetts, Connecticut, and California registration requirements are relatively straightforward, other states may require a more subtle analysis. For example, in New York, the definition of investment adviser is any person who, for compensation, engages in the business of advising members of the public about securities within or from the state of New York[7]. The definition of investment adviser does not include:

- advisers who sold, during the previous 12 months, investment advisory services to fewer than six residents of New York, exclusive of financial institutions and institutional buyers;
- advisers registered with the SEC; or
- advisers who would otherwise be required or permitted to register with the SEC were it not for the exemption from registration under Section 203(b)(3) of the Advisers Act[8].

Section 203(b)(3) exempts from registration any investment adviser who, during the previous 12 months, has had fewer than 15 clients and who neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to a registered investment company. In other words, if an investment adviser:

- is not required to register with the SEC;
- is providing investment advice within or from the state of New York; and
- is not holding itself out to the public as an investment adviser, it may advise up to 14 clients without registering as an investment adviser with the state of New York.

But if an investment adviser:

- is not required to register with the SEC;
- is providing investment advice within or from the state of New York; and
- is holding itself out to the public as an investment adviser, it may advise up to five retail clients and up to 14 private funds that fit within the definition of “institutional buyer[9],” as long as the total client count does not exceed 14, without registering as an investment adviser with the state of New York.

The preceding overview highlights not only the intricacies of certain state securities laws, but also the possibility that an investment adviser that decides to deregister may have to register with one or more states. For example, an investment adviser that is not registered with the SEC, and that has both a place of business located in Connecticut and six retail clients who are residents of Massachusetts, may have to register with both Connecticut and Massachusetts.

The private fund rule amendments

The SEC adopted a number of rule amendments when it adopted Rule 203(b)(3)-2[10]. Recent news articles have suggested that the SEC may yet try to regulate private fund advisers by other means, such as by raising the wealth threshold for accredited investors, and also will re-propose these rule amendments. We analyze below the consequences to private fund advisers should the SEC not re-propose these amendments.

Recordkeeping

The SEC's amendment to the Advisers Act recordkeeping rule permitted private fund advisers that were required to register under Rule 203(b)(3)-2 to market their performance from periods prior to registration, even if they had not kept documentation that SEC rules would otherwise require. This exception applied not only to the adviser's hedge funds, but also to its other accounts. Hedge fund advisers were required to retain whatever records they did have that supported the performance they earned prior to registration, but were excused from the recordkeeping rule to the extent that those records were incomplete or otherwise did not meet the requirements of Rule 204-2(a)(16) under the Advisers Act.

If the SEC does not re-adopt the rule amendment, a hedge fund adviser that has decided to remain registered with the SEC will no longer be able to market its performance from periods prior to registration if its records do not meet Advisers Act recordkeeping requirements. In brief, an adviser must keep all accounts, books, and internal work papers that support the

calculation of performance or rates of return that were included in any documents sent to ten or more clients.

In addition to the performance recordkeeping requirements, if a private fund adviser decides to remain registered with the SEC, the adviser must comply with the Advisers Act recordkeeping requirements, and the SEC generally asserts that it has the authority to review all of the adviser's books and records and its e-mails, even if they are not required records^[11]. In addition to the records of the adviser and the hedge funds it advises, the SEC may also ask to see the records of affiliated entities such as the adviser's parent, subsidiary, or a related entity acting as general partner or managing member of the fund.

If a private fund adviser decides to deregister with the SEC, the adviser will not be required to comply with the SEC's recordkeeping requirements, including more onerous requirements, such as e-mail retention. But a deregistering adviser should maintain records for at least five years to support its performance because:

- it will remain subject to the Advisers Act anti-fraud provisions;
- these records are needed for the fund's audit; and
- these records may be needed to substantiate performance in case of potential lawsuits.

Performance fees

The SEC had adopted an amendment to Rule 205-3, the performance fee rule, to avoid disturbing performance fee arrangements between newly-registered private fund advisers and their current investors and clients. Rule 205-3 permits registered investment advisers to charge performance fees only to "qualified clients" who meet an asset under management or net worth test. The amendment grandfathered existing investors and clients so that they would not have to meet the qualified client test.

Should the Rule 205-3 amendment not be reinstated, a registered adviser that manages a fund relying on Section 3(c)(1) of the 1940 Act would have to look through the fund and determine that each investor is qualified to pay a performance fee, as Rule 205-3 always required^[12]. Non-qualified investors either would have to be redeemed out of the fund or could not be charged a performance fee. The adviser also would have to make the same determination for any separate account clients paying a performance fee.

Custody

Rule 206(4)-2 under the Advisers Act requires registered investment advisers with actual or constructive custody of client assets to implement a set of controls designed to protect client assets from the risks of such custody. Among other things, advisers with custody of client funds and securities must maintain them with "qualified custodians" and deliver (or reasonably believe that the qualified custodian delivers) quarterly account statements to clients ("Account Delivery Requirements").

The SEC amended the custody rule when it adopted the private fund adviser rule to give private funds of funds more time to deliver audited financial statements to investors. In addition, the Rule's definitions of "qualified custodians," particularly its requirements as they relate to qualified custodians acting as offshore prime brokers, are of significant concern to investment advisers in considering whether continued SEC registration is appropriate.

Funds of funds and custody

Rule 206(4)-2 provides an exemption from the Account Delivery Requirements for private funds and fund of funds, provided that the fund or fund of funds^[13] is audited by the independent auditor at least annually, and distributes audited financial statements prepared in accordance with generally accepted accounting principles to all limited partners (or members or other beneficial owners) within 120 days for funds, and 180 days for fund of funds. If this amendment is not re-adopted, advisers to private fund of funds will be forced to distribute audited financial statements to all limited partners (or members or other beneficial owners) within 120 days. This will be problematic for a fund of funds that must wait for the underlying funds' audits before it can finish its own audit.

Offshore prime brokers and custody

Only four types of entities are qualified custodians under the custody rule:

1. a bank[14];
2. a SEC-registered broker-dealer holding client assets in customer accounts;
3. a futures commission merchant[15]; and
4. a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets.

The fourth category of qualified custodians is potentially the most cumbersome for private fund advisers. Many of these advisers use prime brokers to clear and settle securities trades as well as to provide securities lending, margin lending, and other services. US prime brokers come within Rule 206(4)-2's group of qualified custodians, because they are registered with the SEC and hold client assets in customer accounts. The custody rule requires the qualified custodian to keep private fund assets in separate accounts for each private fund under that fund's name, or in accounts that contain only the adviser's funds and securities, under the adviser's name as agent or trustee for the private funds. However, if an adviser custodies a fund's assets with an offshore prime broker, that prime broker must also segregate the private fund's assets from its own under the definition of a "foreign financial institution."

The SEC staff reiterated the Rule's segregation requirements relating to foreign financial institutions in a 2005 no-action letter to the ABA Subcommittee on Private Investment Entities (the "ABA")[16]. The ABA asked the SEC staff whether an adviser could use an offshore prime broker as a qualified custodian under Rule 206(4)-2, explaining that it is typical for UK prime brokers not to segregate certain client assets in certain situations. The SEC staff responded by citing the language of the Rule, noting that if the offshore broker complied with the Rule's requirements (i.e. if it segregated proprietary assets from those of its clients), the offshore broker would be considered a qualified custodian under the Rule. Therefore, under the SEC staff's latest pronouncement, registered investment advisers using offshore prime brokers that do not segregate fund assets from proprietary assets, even if the offshore prime brokers are in compliance with their own jurisdiction's custody requirements, arguably are in violation of Rule 206(4)-2. Barring further evolution of this issue, this position may cause registered advisers to consider deregistering if they have significant offshore custody arrangements that do not comport with the custody rule.

Should you stay or should you go?

Stay with the SEC

By remaining registered with the SEC, an adviser can have more than 14 clients, market itself publicly (and market the fund subject to Regulation D under the Securities Act), and also can manage ERISA plan assets[17]. An adviser also may have a competitive edge over unregistered advisers, as some investors may take comfort from dealing with an adviser subject to inspection. And if an adviser has a place of business in one or more states or a clientele that would otherwise require its registration, dealing with a single regulator is far easier than dealing with different state regulators and varying rules.

Deregister

Withdrawing from registration may mean an adviser must register with one or more states. An adviser with a place of business in a state like New York may be able to deregister with the SEC and avoid state registration – and so avoid intrusive compliance examinations, the need to adopt comprehensive compliance policies, and the costs of maintaining a compliance system and hiring a chief compliance officer. Even if the adviser's offices are in a state like California, state regulation may be preferable to dealing with overly zealous interpretations of SEC rules, such as exam requests to produce all records the adviser has kept, whether or not they are required to be retained.

Advisers should carefully consider their facts and circumstances and their business plans when analyzing the consequences of deregistration with the SEC – most importantly, the possibility of multiple state registration – before filing to deregister. Especially if the SEC restores the rule amendments the Goldstein decision struck down, staying with the SEC – the regulator you know – may be better than registering with a state.

Notes

1. Massachusetts requires registration in the event the investment adviser advises six or more Massachusetts residents.
2. ALM GL ch. 110A, § 401(m) (2006); Conn. Gen. Stat. §36b-6 (2006).
3. Massachusetts requires that the investment adviser has had fewer than six Massachusetts-resident clients in order to meet this condition of the exemption.
4. ALM GL ch. 110A, §401(m)(E).
5. Cal. Corp. Code § 25202.
6. 10 CA ADC § 260.204.9.
7. N.Y. Gen. Bus. Law § 359-eee. See also 13 NYCRR § 11.13.
8. Id.
9. The definition of “institutional buyer” includes “a corporation, Massachusetts or similar business trust, limited liability company, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of \$10,000,000.” 13 NYCRR § 11.12(a)(9).
10. Final Rule: Registration Under the Advisers Act of Certain Private Fund Advisers, Rel. No. IA-2333 (Dec. 10, 2004).
11. See G. Abramovich, SEC Officials to Propose E-Mail Rules for Funds, Money Management Executive (Mar. 13, 2006) (Doug Scheidt, associate director of the Division of Investment Management, stated the SEC would require firms to allow it access to any e-mail messages, including internal communications).
12. Rule 205-3(b).
13. A “fund of funds” is defined by Rule 206(4)-2(c)(4) as a “limited partnership (or limited liability company, or another type of pooled investment vehicle) that invests 10 percent or more of its total assets in other pooled investment vehicles that are not, and are not advised by, a related person (as defined in Form ADV (17 CFR 279.1)), of the limited partnership, its general partner, or its adviser. Form ADV defines a “related person” as “any advisory affiliate, and any person that is under common control with your firm.”
14. Rule 206(4)-2(c)(3)(i) requires that a custodian bank be “as defined in Section 202(a)(2) of the Advisers Act [15 U.S.C. 80b-2(a)(2)] or a savings association as defined in Section 3(b)(1) of the Federal Deposit Insurance Act [12 U.S.C. 1813(b)(1)] that has deposits insured by the Federal Deposit Insurance Corporation under the Federal Deposit Insurance Act [12 U.S.C. 1811].”
15. Rule 206(4)-2(c)(3)(iii) requires that a futures commission merchant should be “registered under Section 4f(a) of the Commodity Exchange Act [7 U.S.C. 6f(a)], holding the client assets in customer accounts, but only with respect to clients’ funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon.”
16. ABA Subcommittee on Private Investment Entities, SEC No-Action Letter (Dec. 8, 2005).
17. All of the assets of a private fund are considered subject to ERISA if more than 25 percent of the fund’s assets are represented by ERISA and other benefit plan assets. ERISA plan trustees generally prefer that their plan’s asset be managed by an “investment manager” – a bank, insurance company, or registered investment adviser.

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