THE INVESTMENT LAWYER ™

covering legal and regulatory issues of asset management

ASPEN PUBLISHERS Vol. 19, No. 4 • April 2012

Regulation of Offshore Advisers Expanded

By Kay A. Gordon and Joshua M. O'Melia

The recently adopted Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which brought about significant changes to the disclosure requirements of the US regulation of offshore advisers, may prove to be a step backwards in such regulation due to its expanding nature. The US Securities and Exchange Commission (SEC) has not to date provided an "official" definition of the terms "offshore adviser" or "foreign adviser," but has used them, generally interchangeably, to describe an investment adviser whose principal office

Continued on page 16

Ms. Gordon is a Partner, and Mr. O'Melia is an associate, in the New York office of K&L Gates LLP. Ms. Gordon can be reached at (212) 536-4038 or *kay.gordon@klgates.com*. Mr. O'Melia can be reached at (212) 536-4078 or *joshua.omelia@klgates.com*.

CONTENTS

Highlights of This Issue
By Stephanie A. Djinis, Editor-in-Chief, page 2

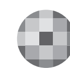
Regulation and Supervision of Financial Planning Under the Securities Laws
Jeffrey O. Himstreet, page 3

Authorization for US Managers under the AIFMD
By Stuart E. Fross and Michael J. Rohr page 25

REGULATORY MONITOR

SEC Update page 35

- SEC Staff Permits Streamlined Registration for Some Investment Advisers



Wolters Kluwer
Law & Business

From the Editor

Highlights of This Issue

Stephanie A. Djinis

The lead article in *The Investment Lawyer's* April issue examines the US regulation of offshore investment advisers. Authored by Kay Gordon and Joshua O'Melia of K&L Gates LLP the article explores the expansion of the Securities and Exchange Commission's (SEC) regulation of offshore advisers brought about by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The article provides detailed background on the regulation of such advisers prior to the SEC's adoption of rules to implement the provisions of the Dodd-Frank Act, discusses the new exemptions for foreign private advisers and private fund advisers, and the requirements for exempt reporting advisers.

Our second article, written by Jeffrey Himstreet of Bingham McCutchen LLP, focuses on the regulation and supervision of financial planning, including background on regulation of investment advisers, fiduciary duties, and the Dodd-Frank Act. The article also discusses the financial planning process in general, and makes note of certain legal and supervisory issues unique to financial planners, such as obligations imposed by the Certified Financial Planners Board of Standards.

This month's third article is authored Stuart Fross and Michael Rohr of K&L Gates LLP. Messrs. Fross and Rohr continue their discussion from the February issue of *The Investment Lawyer* of various aspects of the Alternative Investment Fund Managers Directive (AIFMD) on US money managers. In this current article, the authors discuss how such money managers can prepare for authorization under AIFMD and become compliant therewith. As the authors conclude, "access to Europe via the AIFMD may be an opportunity that is too significant not to embrace, even at the cost of the attendant regulation."

This month's column, by Benjamin Haskin and David Solander of Willkie Farr & Gallagher LLP, highlights the no-action letter recently issued by the SEC Staff to the Subcommittee on Hedge Funds of the American Bar Association—Business Law Section. Such no-action letter provides guidance on a number of issues affecting private fund managers, and permits the so-called "umbrella registration" of certain investment managers in a control relationship with one another.

Stephanie A. Djinis
Editor-in-Chief
Djinis@1940act.com

Regulation and Supervision of Financial Planning Under the Securities Laws

Jeffrey O. Himstreet

The financial markets' uncertainties of the past several years have caused many firms to attempt to develop deeper and more long-lasting client relationships. Many firms, even traditional online brokerage firms, have begun to embrace offering financial planning services as a means to gather and retain client assets. The manner in which an investment adviser conducts and supervises its financial planning business is considerably different than supervising traditional investment advisory activities. A financial planning relationship involves the plan itself, a contract to provide the plan, and may or may not involve a securities recommendation made by the adviser. Performance is important, but the planner/client relationship arguably more so, in addition to the adviser being versed on a wide range of subjects important to most planning clients, such as saving for retirement or education, protection planning (insurance coverage) or charitable giving.

It has been said that financial planning is as much art as science, and is more of a process than a product. The supervision and compliance of financial planning business similarly requires more than a strict adherence to policies and procedures—supervising financial planning business also requires some element of judgment and subjectivity. It is one thing for an adviser to deliver a financial plan and fulfill its contractual obligations, but it is quite another for a supervisor to ascertain whether the plan recommendations are reasonably designed to meet the client's stated objectives and whether the plan is of sufficient quality and consistent with the standards associated with the advisory firm.

The confusion among clients, and to a lesser extent regulatory authorities, regarding the duties owed by their financial professional under broker-dealer and investment advisory regulation has not added clarity for firms overseeing financial planning business lines. Most large firms have some or all of their financial professionals offering financial planning in addition to other investment advisory offerings, such as wrap-fee products, as well as brokerage services, annuities, and insurance products. Persons offering financial planning are also more likely to work with other professionals inside (and outside) their firms, such as accountants, attorneys, bankers, and tax professionals.

Professional credentialing organizations such as the Certified Financial Planner (CFP) Board of Standards, Inc. (CFP Board) and the

---

Mr. Himstreet is Of Counsel with Bingham McCutchen LLP. The author wishes to thank Nicole James Gilchrist, Counsel for Ameriprise Financial Services, Inc. for contributing to the Section entitled "Implementing the Financial Planning Recommendation" of this article.

Chartered Financial Analyst Institute (CFAI) further complicate compliance and supervisory matters by imposing their own standards on members in addition to those required by government agencies and regulatory organizations. Under the current regulatory structure, a typical financial services professional could easily be covered under four or more different standards during the course of a single client meeting:

- Federal and state investment adviser regulations and laws;
- State insurance law;
- Broker dealer regulations; and
- Private credentialing organizations (such as the CFP Board or CFAI).

The purpose of this article is to discuss the regulation of financial planning business regulated under federal and state securities law,[1] highlight legal and supervisory issues unique to firms' substantive oversight of financial planning business, including the supervision of the use of the CFP mark and similar professional designations.

Sources of Regulation

Investment Adviser Regulation

Financial planners oftentimes provide advice about securities in the context of preparing an investment allocation intended to fund retirement or a major purchase and as such are providing advice about securities and are regulated as investment advisers under applicable federal and state law. Advisers have also been deemed fiduciaries for purposes of common law and state consumer protection laws given the nature of the relationship, judicially described as one of trust and confidence between adviser and client.

Fiduciary Obligations of Investment Advisers

The Investment Advisers Act of 1940 (Advisers Act), while not mentioning the word "fiduciary," contains antifraud prohibitions applying to all persons meeting the "investment adviser" definition, regardless of whether the adviser is registered with the Securities and Exchange Commission (SEC). The antifraud provisions of the Advisers Act have long been interpreted as imposing a fiduciary duty on investment advisers.

The US Supreme Court, in *SEC v. Capital Gains Research Bureau,*[2] held that an investment adviser is a fiduciary that owes its clients "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts."[3] The case involved an adviser that was buying securities in its own account and then recommending the same securities to clients. The adviser then sold the shares for a profit on the price rise that generally followed these recommendations. The SEC argued that these transactions were essentially "a fraud or deceit upon any client or prospective client," and thereby prohibited under section 206(2) of the Advisers Act.

ASPEN PUBLISHERS

Copyright © 2012 by CCH Incorporated.
All Rights Reserved

The Investment Lawyer (ISSN 1075-4512) (USPS P0000-062) is published monthly by Aspen Publishers, at 76 Ninth Avenue, New York, NY 10011. Postmaster: Send address changes to *The Investment Lawyer*, Aspen Publishers Distribution Center, 7201 McKinney Circle, Frederick, MD 21704.

Permission requests: For information on how to obtain permission to reproduce content, please go to the Aspen Publishers website at *www.aspenpublishers.com/permissions.* **Purchasing reprints:** For customized article reprints, please contact *Wright's Media* at 1-877-652-5295 or go to the *Wright's Media* website at *www.wrightsmedia.com*.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other professional assistance is required, the services of a competent professional person should be sought.—From a *Declaration of Principles* jointly adopted by Committee of the American Bar Association and a Committee of Publishers and Associations.

Visit Aspen's Web site *www.aspenpublishers.com*

Although the defendants in *Capital Gains* made the case that they believed their recommendations were in fact in the best interest of their clients, the Court found that despite an absence of client harm, failing to reveal these conflicts caused the adviser to breach its fiduciary duties to its clients. The stated purpose of this fiduciary duty is to eliminate conflicts of interest and prevent an adviser from taking unfair advantage of its clients' trust or otherwise overreaching. The specific obligations that the SEC has indicated flow from an adviser's fiduciary duty that are applicable to financial planning include duties to (a) have a reasonable, independent basis for its investment advice;[4] (b) only provide suitable investment advice;[5] (c) refrain from effecting personal securities transactions inconsistent with client interests;[6] and (d) uphold a duty of loyalty to clients.[7]

Compare this duty with a traditional suitability requirement imposed on registered representatives of a broker-dealer. When acting as a registered representative, the representative's initial responsibility is as an agent of his employer. Under this standard, recommendations to clients must be suitable, but not necessarily the best possible solution available or one that is arrived at free of conflicts of interest.

The difference between suitability and fiduciary standards becomes clear by reviewing a typical brokerage account disclosure attached to account applications or marketing materials that may read:

> Our interests may not always align with yours. Please ask questions to make sure you understand your rights, and our obligations to you, including the limitations of our obligations to disclose conflicts of interest and to act in your best interest.

The Dodd-Frank Act and Fiduciary Issues

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[8] attempted to begin the process of reconciling the disparity of regulation between investment advisers and broker-dealers. It required the SEC to conduct a study (the Study) to evaluate: the effectiveness of existing legal or regulatory standards of care (imposed by the SEC, a self-regulatory organization, and other federal or state authorities) for providing personalized investment advice about securities to retail customers; and whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory requirements in the protection of retail customers that should be addressed by rule or statute. The Dodd-Frank Act does not require the SEC to adopt fiduciary rules, but does specify that any fiduciary standard adopted for persons providing advice about securities to retail clients be no less stringent than the standard imposed by the Advisers Act.

Section 913 of the Dodd Frank Act also includes 14 items that the SEC must consider in conducting the Study. The considerations address the following areas, among others:

- Whether retail customers understand or are confused by the differences in the standards of care that apply to broker-dealers and investment advisers;
- The regulatory, examination, and enforcement resources to enforce standards of care;
- The potential impact on retail customers if regulatory requirements change, including their access to the range of products and services offered by broker-dealers;
- The potential impact of eliminating the broker-dealer exclusion from the definition of "investment adviser" under Advisers Act; and
- The potential additional costs to retail customers, broker-dealers, and investment advisers from potential changes in regulatory requirements.

As required by Section 913, the resulting SEC Study describes the considerations, analysis and public and industry input that the Staff considered in making its recommendations, and it includes an analysis of differences in legal and regulatory standards in the protection of retail customers relating to the standards of care for broker-dealers, investment advisers and their associated persons

for providing personalized investment advice about securities to retail customers.[9] The Staff recommended establishing a uniform fiduciary standard for investment advisers and broker-dealers when providing investment advice about securities to retail customers that is consistent with the standard that currently applies to investment advisers.

Evolution of Federal and State Regulation of Financial Planners

The "Early Days" of Financial Planning Regulation

By 1985, 37 states required the registration of investment advisers. The North American Securities Administration Association, Inc. (NASAA), an association of state securities authorities, at the time estimated that there were approximately 200,000 self-proclaimed financial planners in the United States, while fewer than 10,000 were registered with the SEC as investment advisers. The net effect was that many thousands that should have been registered as investment advisers under federal and state law were not.[10]

The state registration process for financial planners involves registering the firm as an investment adviser in each state where it conducts business. To date, all states except Wyoming require the registration of financial planners that are acting as investment advisers.[11] State investment adviser registration consists of filing Form ADV electronically on the Investment Adviser Registration Depository (IARD).[12] State-registered advisers must also complete an additional section of Form ADV, Part 1B, which is inapplicable to SEC-registered advisers, and asks questions regarding minimum capital and bonding, and additional questions relating to disciplinary or other past history that a state securities authority may consider in determining whether to approve the registration of the firm and/or its affiliated persons.[13]

Advisers Act Release No. 1092

The SEC and the states sought to address the lack of registration by financial planning firms by jointly releasing Advisers Act Release No. 1092,[14] (Release IA-1092) which has long held that a person is acting as an investment adviser and, thus, subject to the Advisers Act, if it satisfies the compensation test and is "in the business" of providing advice. The person is in the investment advisory business if it:

(i) Holds itself out as providing investment advice,
(ii) Receives "any separate or additional compensation that represents a clearly definable charge for providing advice about securities, regardless of whether the compensation is separate from or included within any overall compensation, or receives transaction-based compensation if the client implements the investment advice," or
(iii) On something other than a periodic basis, provides specific investment advice.[15]

The SEC clarified in Release IA-1092 that the "in the business" test requires that the business be related at least in part to securities. The SEC stated that "for the purposes of (iii) above, 'specific investment advice' includes a recommendation, analysis, or report about specific securities or specific categories of securities (for example, industrial development bonds, mutual funds, or medical technology stocks). It includes a recommendation that a client allocate certain percentages of his assets to life insurance, high yielding bonds, and mutual funds or particular types of mutual funds such as growth stock funds or money market funds. However, specific investment advice does not include advice limited to a general recommendation to allocate assets in securities, life insurance, and tangible assets."[16]

Release IA-1092 had two effects: First, a large number of financial planners that previously had not registered with the SEC were now constructively aware that they were subject to SEC registration, thereby greatly increasing the number of SEC-registered advisers. This influx of new registrants furthered discussions about the future regulation of investment advisers, culminating in the enactment of the National Securities Markets Improvements

Act of 1996[17] (NSMIA) (discussed below), which reallocated regulatory responsibilities between the SEC and the states. Second, the states were faced with an increasing obligation to begin to more fully regulate financial planners conducting business within and from their borders. Release IA-1092 was unique in that it was a joint release where federal and state (through NASAA) regulators expressed their collective view that persons that provide advice about securities in connection with providing financial planning were subject to investment adviser regulation.

State Investment Adviser Representative Licensing and Qualification

Most states also require the registration of investment adviser representatives (IARs). An investment adviser representative under state law is a person who provides advice about securities on behalf of the investment adviser, supervises a person providing investment advice, or solicits advisory clients for an investment adviser. The registration process for IARs is based largely on the Financial Industry Regulatory Authority (FINRA) registered representative registration process, whereby the firm submits a Form U-4 electronically to apply for registration for its representatives and then selects the state(s) in which the representative is seeking registration. As a condition of state registration, IARs must also either pass a qualification examination or obtain certification from one of a number of organizations, such as the CFP Board, CFAI, and several others. State waivers from the examination requirement for those advisers holding the CFP or other marks vary from state to state and as such any IAR seeking an examination waiver must inquire with the appropriate state securities authorities to ascertain whether the designation the IAR has obtained will be recognized by the state.

Reallocation of Federal and State Investment Adviser Authority Under NSMIA and Dodd Frank

NSMIA reallocated federal and state responsibilities for the regulation of investment advisers that at the time registered both with the SEC and with the states.[18] After NSMIA, the SEC was primarily responsible for larger firms and the states for smaller firms. The Dodd-Frank Act created a new category of "mid-sized advisers" and shifted primary responsibility for their regulatory oversight to the states by prohibiting from SEC registration an adviser that is required to be registered as an investment adviser in the state in which it maintains its principal office and place of business and that has assets under management between $25 million and $100 million.[19] Unlike a small adviser, a mid-sized adviser must register with the SEC:

(i) If the adviser is not required to be registered as an investment adviser with the securities commissioner (or any agency or office performing like functions) of the state in which it maintains its principal office and place of business; or

(ii) If registered with that state, the adviser would not be subject to examination as an investment adviser by that securities commissioner.[20]

Currently New York and Minnesota have stated that they do not have examination programs and as a result, mid-sized advisers with a principal office and place of business in either state must remain registered with the SEC.

The SEC has authority to exempt advisers from the prohibition against SEC registration if the adviser, despite not having $100 million of assets under management, is controlled by or under common control with a SEC-registered adviser and both advisers have the same principal place of business.[21] Many large, diversified firms may offer financial planning in addition to other investment advisory services, such as discretionary management services and wrap fee programs, each through different investment advisers but from the same principal office and place of business. Rule 203A-2(c) allows such a firm to register its financial planning investment adviser with the SEC even though the assets managed may be by another, affiliated investment advisory firm with the same principal office and place of business.

Financial planning firms ineligible for SEC registration must register with the appropriate

state securities authorities. The "assets under management" test requires that the adviser provides "continuous and regular supervisory or management services to the client portfolios."[22] The instructions to Form ADV state that, for nondiscretionary investment advice such as that offered by financial planners, "continuous and regular" means the adviser has "ongoing responsibility to select or make recommendations, based upon the needs of the client, as to specific securities or other investments the account may purchase or sell and, if such recommendations are accepted by the client, [the adviser is] responsible for arranging or effecting the purchase or sale."[23] Factors to consider in assessing whether a financial planner (or any other adviser) has continuous and regular supervisory or management services includes whether the terms of the advisory contract obligate the adviser to provide ongoing management services; whether the advisory fee is calculated as a percentage of assets under management, and whether the adviser actively manages assets or provides advice.[24]

Whether a financial planner could reasonably claim to be providing continuing and regular management services and thus be eligible for registration with the SEC depends on the nature and scope of the financial planning relationship. Basic guidance on personal finance such as "spend less and save more" probably would not "count" as assets under management by the adviser. Customized guidance, such as producing a general, broad asset allocation suggestion based on information provided by the client similarly would be unlikely to constitute continuous and regular management services. While the SEC Staff has not specifically stated whether providing ongoing financial planning would constitute "continuous and regular," many financial planning firms have apparently concluded that they are performing continuous and regular management services and thus registered with the SEC.

NSMIA also limited states' abilities to require registration of investment adviser representatives of SEC-registered investment advisers. NSMIA limited state registration of investment adviser representatives of SEC-registered advisers to those representatives that have a place of business (that is, a physical presence) in a given state.[25] SEC rulemaking also limited the scope of the term "investment adviser representative" to those persons that solicit, communicate, or provide investment advice to principally retail clients (that is, those clients that have less than $1 million under management with the adviser or have a net worth of less than $2 million (exclusive of the client's primary residence)).[26]

The Business of Financial Planning—What Is It?

The foregoing discusses in some detail when a person offering financial planning services is subject to regulation as an investment adviser, but what is financial planning generally? Several definitions abound, including that offered by the CFP Board and imposed on its certificants (as discussed *infra*), which defines financial planning as "the process of determining whether and how an individual can meet life goals through the proper management of financial resources."[27] "Life goals" include various topics for which a person may seek the assistance of a financial planner: investment planning; income tax planning; education planning; risk management (such as assuring proper insurance coverage) planning; retirement planning; and charitable giving.[28]

Financial planning has been described as a process rather than a product. According to the CFP Board, the financial planning process consists of the following six actionable, repeatable steps:

(i) Establishing and defining the client-planner relationship;
(ii) Gathering client data including goals;
(iii) Analyzing and evaluating the client's current financial status;
(iv) Developing and presenting recommendations and/or alternatives;
(v) Implementing the recommendations; and
(vi) Monitoring the recommendations.[29]

Establishing and Defining the Client-Planner Relationship

An investment adviser engaging in financial planning is seeking to establish a

contractual relationship with the client. The adviser, although not specifically required by the Advisers Act, typically explains or documents the services to be provided to the client and defines both parties' rights and responsibilities. These responsibilities include how the adviser will be paid and by whom. The client and the planner also should agree on how long the professional relationship should last and on how investment and other planning decisions will be made, how advice will be communicated to the client, and how (or whether) any recommendation will be implemented.[30]

Gathering Client Data, Including Goals

The financial planner typically first asks for information about the client's financial situation. The client and the planner should mutually define the client's personal and financial goals, understand the client's time frame for results and discuss relevant risk tolerances. The financial planner also should gather all the necessary documents before giving the client the advice he or she needs.[31] Many planners use a data gathering worksheet or template to facilitate the collection of client data from various sources. The information gathering process may be time-consuming, in that it involves the collection of brokerage and bank account statements, insurance policies, and 401(k) records, in addition to tax returns and estate planning documents.

Analyzing and Evaluating Clients' Financial Status

The financial planner then should analyze the client's information to assess his or her current situation and determine what must be done to meet the client's goals. Depending on what services the client has asked for, this could include analyzing the client's assets, liabilities and cash flow, current insurance coverage, and investments or tax strategies.[32] Firms oftentimes rely on financial projections generated by commercially available software to generate projection data to illustrate the likelihood of the client reaching his or her goals.[33]

Developing and Presenting Financial Planning Recommendations and/or Alternatives

The financial planner typically next offers financial planning recommendations reasonably designed to address the client's goals, based on the information the client provides in the data gathering process. The planner goes over the recommendations with the client to help him or her understand them in order to make informed decisions. Any concerns expressed by the client should also be considered, with the adviser revising the recommendations as appropriate.[34]

Implementing the Financial Planning Recommendations

The client and the planner also should agree on how the recommendations will be implemented. The planner may carry out the recommendations or serve as the client's coach—coordinating the whole process with the client and other professionals, such as attorneys, accountants, and/or registered representatives.[35] A client's goals may be implemented at the planner's firm, or at a firm of the client's choosing. The financial planning contract should clarify whether the recommendations are to be implemented at a broker-dealer with which the planner is associated or one of the client's choosing (that is, a "portable" plan).

Monitoring the Financial Planning Recommendations

The client and the planner should agree on who will monitor the client's progress towards the client's goals. If the planner is in charge of the process, she should report periodically to review the client's situation and adjust the recommendations, if needed, as the client's life changes.[36] A best practice is to provide some type of written progress report to the client. If the planner is assuming no role in the monitoring of the client's progress then the agreement should expressly disclaim responsibility for monitoring and oversight.

Compliance and Supervisory Issues Unique to Financial Planning

Investment advisers offering financial planning services must contend with several legal, compliance, and supervisory issues that are distinct from and often times more complex than a more traditional asset management business. These issues include:

- The financial planning agreement;
- Financial planning fees;
- Supervising the financial planning process and the plan itself;
- Recordkeeping issues; and
- Supervisory issues specific to holders of marks issued by private credentialing organizations such as the CFP.

The Financial Planning Agreement

In addition to the typical clauses and issues pertinent to investment advisory agreements, such as the limitation on assignments and the manner in which fees are charged, financial planning agreements as a matter of practice require additional considerations. The financial planning agreement typically spells out the financial planning process or which portions of the financial planning process the adviser is undertaking to deliver, such as assessing goals and making recommendations.

Another topic is the time when the plan is to be delivered to the client. When does the adviser intend to deliver the initial recommendations to clients? Anytime during the course of the engagement, or within some stated period of time such as 120 days after the effective date of the agreement? Is the adviser obligating to meet with the client at regular intervals during the course of the engagement (for example, quarterly)? What topics does the adviser plan on covering pursuant to the initial recommendations? Are there other topics or goals to track over time such as future goals? If clients complain about a financial plan being delivered late or not covering the topics as the client agreed to, should the firm offer a refund? Should the delivery schedule for plans issued in subsequent years follow the same delivery as in the first year? These are all issues that the adviser can and should address in the financial planning agreement.

Firms that have promised delivery of a plan by a date certain but have not enforced that delivery date or monitored to assure that delivery has occurred have been subject to enforcement action.

It is important for financial planning firms to have some mechanism to assure that financial plans are delivered to clients in a manner consistent with the contractual obligations assumed by the firm and its representative(s). Delivery dates for financial planning creates unique challenges. First, the client is obligated to gather what oftentimes is a tremendous quantity of data for the adviser to analyze when preparing a financial plan, and an adviser that obligates itself to deliver a financial plan within a stated number of days after the effective date of the agreement must consider the amount of time that it will take clients to gather the documents and data needed by the adviser. Otherwise the adviser is setting itself up to violate the terms of the agreement by not delivering the financial plan by the agreed-upon time. Similarly, if clients refuse to provide the necessary statements, paperwork, and information, it can become difficult to meet agreed-upon deadlines.

Advisers have several options to address deliverable dates. One is to not enter into the financial planning agreement until the adviser has the necessary client information. Another is to amend the agreement so that the adviser is delivering within the agreed-upon, revised, delivery date. Still another is to leave ample "room" in the agreement, such as six or nine months, which may address delivery issues, but may create challenges in managing the adviser's practice in terms of when deliverables are owed to clients. Another is for the firm to create incentives such as adjusting an adviser's compensation (and refunding client fees) for failure to meet delivery dates.

Many advisers address plan production issues by outsourcing some or all of the plan creation and data analysis. Some of this can be accomplished through the use of financial planning software that will generate a financial plan after the financial planner or someone on the planner's staff enters the necessary data by hiring plan production staff, or by contracting

with a third party to prepare the financial plan. If the financial planner is outsourcing the review work to a person not affiliated with the investment adviser, the adviser must take steps to assure that client privacy is protected and that the adviser is in compliance with its privacy procedures and disclosures. Issues concerning the capabilities and competency of the outsourced person must be addressed because any recommendation made remains the planner's responsibility.

While not required by law, many advisers send a confirmation letter to clients, akin to a brokerage confirmation, affirming that the client has signed a financial planning agreement and that the client can expect to receive written recommendations within the agreed-upon time period. An adviser that delivers financial planning confirmations is helping to protect itself against a client denying that it entered into a financial planning relationship and an investment adviser representative engaging in misconduct by "manufacturing" financial planning relationships.

Financial Planning Fees

Financial planning fees pose supervisory and compliance challenges in part because financial planning fees are often in addition to other investment advisory fees, brokerage commissions, and mutual fund expenses, in many cases collected by affiliates of the planner. Also, every plan is different (or at least should be, based on the unique circumstances of each client) and some planners moreover may be able to command higher fees than others, making it more difficult to discern the reasonableness of a planning fee. Important keys to financial planning fees are that they be (i) fair in relation to the services being offered and the fees being charged to similarly situated clients; and (ii) fully disclosed and consented to by the client. Conceptually this approach sounds simple enough, but in practice it can prove challenging to implement and monitor.

What Is a Reasonable Fee?

An adviser's fiduciary obligations require it to charge fees that are reasonable for the services provided. For a traditional separate account manager, a standard fee schedule typically suffices since the investment management services it provides do not typically change from client to client unless the client was able to negotiate a rate that differs from the stated rate. For example, clients investing in the small-cap strategy of Manager X will receive similar investment management services and the variance in fees will largely be dependent on the size of the client's account.

There conversely are several variables in a financial planning relationship. One factor is the financial planner's experience and background. Like accountants and attorneys, more skilled and seasoned financial planners, including those that have obtained the CFP mark or who have developed specialized skills such as an expertise in tax or estate issues, can command a higher rate than someone new to the profession with little experience. Geographical location also factors into fees, as a financial planner in a large metropolitan area may be able to command a higher fee than a similarly-skilled planner in a smaller community. Another is how the planner will charge for its services. Whether a planner charges hourly, per plan, based on the value of the assets that are covered by the planning arrangement (or some combination of the three) varies from practice to practice. A third is how complex the client's financial plan is and what services he or she is expecting from the adviser.

Supervising the Reasonableness of Financial Planning Fees

Once a planner has established a fee, the adviser is obligated to supervise the assessment of fees by its planners. This supervisory obligation requires that the adviser is aware of the fee that the planner charges, approve any changes, and that the planner charges similarly situated clients a comparable fee. A planner's fiduciary duties obligate it to charge a fair price to all clients, and not give a lower fee to one client and recoup the profits lost through the lower fee by charging a similarly situated client a higher fee for a comparable services.

Relationship of Financial Planning Fees to Other Fees Charged by the Adviser

An adviser also cannot "double dip" by charging the client twice for the same service. Advisers must be mindful of the client that purchases a financial plan with investment planning as a goal, for example, and is then charged an investment management fee to implement the plan and manage the assets that are invested to meet that retirement goal. Is the client being charged twice for the same advice? The planner may be implementing a portion of the assets with the client implementing the rest at another firm or through the client's employee benefit plan. The planner also may provide more long-term recommendations through the financial plan, such as a plan to meet the client's investment goals in the next twenty years, but the implemented assets represent a more short-term investment strategy.

Even if the assets in an advisory account are covered by a financial plan in an appropriate manner, the important issue for the adviser is to be able to identify situations that raise the possibility of double-dipping to address regulatory and litigation risk. It is critical for the adviser to adopt policies and procedures to document the investment advice given under each relationship and that it be transparent to the client which relationship governs the advice received. From a supervisory perspective, the adviser should consider developing the functionality to be able to generate a report that lists client goals that are duplicative between a financial planning relationship and another investment advisory relationship with the adviser, such as a separate account or wrap-fee arrangement, or brokerage account through which the recommendations are implemented.

Advisers, through their supervisory personnel, oftentimes supervise fair pricing issues by reviewing financial plans prepared by the same financial planner to similar clients receiving similar plans (that is, two planning clients with similar goals, such as retirement, and having roughly the same assets and risk tolerances should be charged similar fees). Discrepancies in fees between similarly situated clients can be addressed through fee remediation and supervision of the fees charged by the planner and perhaps additional training for the planner to avoid such disparate treatment in the future. At a minimum, the advisory firm should make clear disclosure that two similarly situated clients may be charged different fees for the same services.

One other issue in connection with fees is the aggregate amount of investment advisory fees. For example, the financial planner may seek to implement the financial planning recommendations through a non-discretionary wrap-fee program or a brokerage account. While a financial planning fee may appear reasonable in isolation, it may become unreasonable if it is incurred in addition to a wrap-fee program that charges a fee of two percent on the assets managed within the wrap-fee account. The SEC Staff has historically stated that advisory fees, in total, that exceed three percent per year require additional disclosure essentially informing the client that he or she could likely receive comparable services from another adviser for a lower fee.[37] Advisers offering both financial planning and other investment advisory services oftentimes add the two together and rebate any excess to remain within a three percent cap.

As with all fees, the financial planning fees must be covered in the adviser's Form ADV. Form ADV, Part 2 requires that advisers disclose the types of financial planning fees charged, how they are determined, and whether they will be netted against other investment advisory services. For an investment adviser with a large and varied number of persons providing financial planning, this disclosure will be more general, by necessity, as it would be impracticable to list the fee schedules for several dozen or several hundred financial planning professionals.

Supervisory Issues Unique to Planning

The nature of financial planning imposes unique supervisory challenges for financial planning firms. Chief among these challenges is assuring that the financial plan has been delivered as promised and that the adviser has fulfilled its contractual and suitability obligations. Financial plans oftentimes are prepared and delivered remotely, akin to client

correspondence and away from the adviser's central supervisory structure.

How does the adviser know that the financial planner has made good on its contractual obligation? Many firms have developed systems to monitor and track plan delivery and established automated protocols to remind a financial planner of his or her obligations if the plan is undelivered, and ultimately, refund the client's financial planning fee (and the planner's compensation for the undelivered financial plan) if the plan is not delivered within the proscribed time frame.

Another challenge is providing some assurance that the plan is of reasonable quality, consistent with the "look and feel" of other offerings by the adviser, and designed to meet the client's stated goals. A planning client that has a stated goal of retirement planning should not receive a financial plan that is geared towards insurance protection needs.

The financial plans delivered by a single financial planner also should not be "cookie cutter" plans that are the same for all or most of the planner's clients. For the planner and the adviser to meet the suitability obligations that result from the adviser's fiduciary duties, financial plans should be tailored to each client. Financial plans also should be of a quality that reflects the adviser's overall reputation and positioning in the marketplace, and for the financial planning fee assessed and collected by the adviser.

Recordkeeping Issues

Financial plans delivered to clients are also subject to the Advisers Act recordkeeping requirements under Rule 204-2 or applicable state law (for mid-sized and smaller advisers). Rule 204-2(a)(7) requires retention of communications relating to investment advice, the receipt or disbursement of cash or securities, and trade records. The financial plan presumably would contain a recommendation concerning securities and therefore must be retained for five full fiscal years after the plan is delivered to the client. Addendums to the plan similarly would have to be retained, as would copies of the investment advisory agreement (and amendments) that created the financial planning relationship.

Obligations Imposed by the Certified Financial Planners Board of Standards on CFPs

Many financial planners have obtained certification by the CFP Board, which is a private, nongovernmental professional organization. It imposes educational and reporting requirements on those persons holding the CFP mark (also referred to as certificants) and can discipline certificants for misconduct, up to and including prohibiting them from using the CFP mark. Today the CFP Board remains a non-profit organization and primarily develops educational financial planning programming, testing and certification standards, and ethical standards of professional conduct for its certificants.[38] The CFP Board also enforces its professional conduct standards through investigatory and disciplinary procedures.

Anyone seeking to become a Certified Financial Planner must complete the CFP certification process. The CFP certification process has four main components: education, examination, experience and ethics. Once an individual meets the standards set by the CFP Board, he or she is permitted to use the CFP "marks." An individual may only use CFP, Certified Financial Planner™ and CFP mark in her business materials as prescribed by CFP certification standards. The CFP has trademarked the "certified financial planner" moniker and its acronym and logo. An applicant must also pay a one-time application fee and certificants pay a biennial certification fee and must satisfy ongoing continuing education requirements. The CFP has the authority to examine certificants and has enforcement authority over certificants, with the ability to deny the use of the mark for a stated period of time or prevent one from using it indefinitely.

Although the CFP (and similar) marks apply to the representative, rather than the investment advisory firm, the firm is not without some supervisory obligations to ensure that the representative is using the mark appropriately. The SEC for example has stated that a representative that holds itself out as maintaining the CFP mark when in fact the representative does not, could violate the antifraud provisions of the Advisers Act. Advisers thus must maintain a database of all persons

holding the CFP mark to assure that the representatives' business cards and letterhead accurately reflect the designation(s) held by the representative and that the representative is current in his or her continuing education obligations with the CFP.

Conclusion

Since the inception of financial planning services, the regulation of the financial planning process and the professionals who provide these services continues to evolve and grow more complex. Many agencies and self-regulatory organizations and professional associations have expressed interest in additional oversight of the practice, but as continued discussions of regulatory harmonization for the financial services industry occur, it is unclear whether one of these, if any, will emerge as the primary regulator of financial planning services. Regardless, firms that have chosen to engage in financial planning pose unique supervisory and compliance challenges that must be addressed to satisfy the fiduciary duties owed to clients.

Notes

1. A discussion of the other areas of regulation to which a planner may be subject, such as state insurance law, or the regulation of other professions such as accountants or attorneys that offer financial planning is beyond the scope of this article.

2. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963).

3. *Id.* at 194.

4. *See In re Alfred C. Rizzo*, Inv. Adv. Act Rel. No.897 (Jan. 11, 1984).

5. *See* John G. Kinnard and Co., SEC No-Action Letter (pub. avail. Nov. 30, 1983); *see also* Inv. Adv. Act Rel. No.1406 (Mar. 16, 1994) (proposing a suitability obligation for investment advisers). The SEC has sanctioned financial planning firms for making unsuitable recommendations. *See In re Westmark Financial Services Corp*., Inv. Adv. Act Rel. No.1117 (May 16, 1988) (financial planner recommended speculative equipment leasing partnerships to unsophisticated investors with modest incomes).

6. *See* Inv. Adv. Act Rel. No.203 (Aug. 11, 1966).

7. *See* Advisers Act Release No.40 (Feb. 4, 1945) and Inv. Adv. Act Rel. No.232 (Oct. 16, 1968).

8. Pub. L. 111–203, 124 Stat. 1376 (2010).

9. SEC, Study on Investment Advisers and Broker-Dealers (Jan. 2011) available at *http://sec.gov/news/studies/2011/913studyfinal.pdf*.

10. Fraud and Abuse in the Financial Planning Industry, NASAA-Reports (CCH) ¶8209a (Aug. 1985).

11. Wyoming has long stated that it does not have a sufficient number of potential applicants to justify the expense of administering an investment adviser regulatory program.

12. *See* IARD Home Page, available at *www.iard.com.*

13. Part 1B of Form ADV, available at *http://nasaa.org/content/Files/1BandDRP.pdf.*

14. Inv. Adv. Act Rel. No.1092 (Oct. 8, 1987).

15. *Id.* at § II.A.2.

16. *Id.*

17. National Securities Markets Improvements Act of 1996, Pub. L. No. 104-290,110 Stat. 3416 (1996).

18. *See Id*.

19. *See* Section 410 of the Dodd-Frank Act (adding new section 203A(a)(2) of the Advisers Act). This amendment increases the threshold above which all investment advisers must register with the SEC from $25 million to $100 million. *See* S. Rep. No. 111–176, at 76 (2010).

20. *See Rules Implementing Amendments to the Investment Advisers Act of 1940*, Inv. Adv. Act Rel. No. 3221 (Jun. 22, 2001) (adopting rules to implement the registration switch for mid-sized advisers).

21. Advisers Act Rule 203A-2(c).

22. *See* Form ADV, Part IA (Instruction 5(b)(5)).

23. *See id.*

24. *Id.*

25. *See* Advisers Act 203A(b)(1)(A).

26. Advisers Act Rule 203A-3(a) (definition of "investment adviser representative," which cross-references Advisers Act Rule 205-3 to define exceptions to the definition for persons that only have as clients those persons who are "qualified clients"). *See also Investment Adviser Performance Compensation*, Inv. Adv. Act Rel. No. 3372 (Feb. 15, 2012) (increasing the assets-under-management and net worth tests for determining whether performance fees can be charged to a particular client).

27. CFP Board of Standards, Standards of Professional Conduct 4-5 (Aug. 2009) (CFP Standards of Professional Conduct), available at *www.cfp.net/Downloads/2009Standards.pdf.*

28. *See id.* at 5.

29. *See id.*

30. *Id.* at 10.

31. *See id.* at 18-19.

32. *See id.* at 21.

33. Financial planning firms that are affiliated with registered broker-dealers should be aware of the limitations on projections imposed by FINRA.

34. *See* CFP Standards of Professional Conduct, at 23-24.

35. *See id.* at 26-27.

36. *See id.* at 28.

37. *See* Standard & Poor's Corp., SEC No-Action Letter (Nov. 23, 1975) ("we have serious doubts about charging a straight [3%] service charge with no maximum dollar amount"). The SEC Staff has stated that if an adviser charges fees which are substantially higher than normally charged in the industry, he (it) must make disclosure of that fact to such client. Crystal Securities Corporation, SEC No-Action Letter (Jan. 4, 1974); Kinnaid Technical Advisory Service, SEC No-Action Letter (Nov. 30, 1973); Knowles and Armstrong, SEC No-Action Letter (Apr. 16, 1974). A minimum fee may violate section 206 if the portfolio of the client is too small in relation to the fee. Runyon Associates—Consultant Publications, Inc., SEC No-Action Letter (Nov. 17, 1974).

38. Purpose, Parameters and Policies of CFP Board, available at *www.cfp.net*.

Offshore Advisers . . .

Continued from page 1

and place of business are located outside of the United States.[1] Given a great variety of different types of such advisers (in terms of their jurisdictions of origin, size, services provided, etc.) and their significant number, regulating such advisers can be a daunting task. Prior to the adoption of the Dodd-Frank Act, the SEC generally came to favor a regulatory approach based on the conduct of such advisers and the effects of such conduct on US investors and otherwise, US soil.[2] The SEC has modified its approach recently in a series of new rules adopted to implement the provisions of the Dodd-Frank Act.

Background

The SEC's treatment of offshore advisers under the US Investment Advisers Act of 1940, as amended (the Advisers Act) has evolved significantly over the last 30 years, with the age-old question being whether an offshore adviser's business with offshore investors and clients is subject to the Advisers Act and all of its regulatory requirements. Before 1992, the SEC's analysis with respect to whether an offshore adviser needed to register and/or be subject to the various regulatory requirements under the Advisers Act was based on an "entity" approach—that is, any offshore adviser doing business in the United States and registered with the SEC had its entire business subject to the substantive provisions of the Advisers Act,[3] generally without regard to whether that business was for US or non-US clients.

The entity approach has its roots in the oft-cited 1981 SEC *Richard Ellis* no-action letter.[4] The *Richard Ellis* letter took on the question of whether a subsidiary entity could be registered with the SEC as an investment adviser and, in effect, shield its unregistered offshore parent from being subject to the registration and substantive compliance provisions of the Advisers Act. Applying an entity approach, the SEC Staff evaluated the situation using what have become known as the "*Ellis* Conditions." Under the *Ellis* Conditions, an offshore parent may avoid the reach of the Advisers Act so long as (a) its subsidiary is adequately capitalized; (b) an adequate "buffer" is established between the personnel of the subsidiary and parent, including a board of directors consisting of a majority of members independent from the offshore parent; (c) advisory personnel remain segregated—meaning no US personnel may engage in the advisory business of the offshore parent, and vice versa; (d) the subsidiary and parent make independent investment decisions, derived from sources independent of one another; and (e) the subsidiary keeps its investment advice confidential until communicated to clients. If the SEC was not persuaded by the separation created between a registered subsidiary and its offshore parent, the parent may have needed to register as well. Clearly, the framework created by the *Ellis* letter put a heavy burden on an offshore adviser if it wanted to remain outside the jurisdiction of the Advisers Act. Setting aside the cost outlay in providing for proper independent capitalization, an offshore adviser would then have needed to staff its subsidiary with duplicate personnel who would perform essentially the same function as its offshore personnel, except that they would service US clients and investors. It is easy to see why this structure was not ideal for offshore advisers; in some cases, it might have been easier for an offshore parent to register and succumb to Advisers Act regulation so it could utilize its entire staff for both offshore and US activities. However, registering the entire business under the Advisers Act could often subject the parent adviser to duplicative and sometimes contradictory requirements of different jurisdictions with the adviser having to face the need to try to harmonize such contradictory requirements or to choose which requirements were more important. The entity test needed to give way to a new course; a more practical framework that would put less of a financial and regulatory burden on offshore advisers.

In 1992, the SEC made a course correction. On May 29, 1992, the SEC published a report, entitled *Protecting Investors: A Half-Century of Investment Company Regulation* (the Report). The Report covered a wide range of topics, one of which was a reconsideration of the SEC's "entity" approach to offshore

adviser regulation. Instead of applying the substantive provisions of the Advisers Act to all of an offshore adviser's business activity, the SEC introduced a "conducts and effects" test, which would evaluate whether a "sizable amount" of an adviser's activity, or of such activity's effects, took place within the United States. If so, the Advisers Act was more likely to apply. The result of this new approach would be that the activities of an offshore adviser providing advisory services from outside the United States for a non-US client or investor would not be subject to the full substantive provisions of the Advisers Act including the requirement to register under such Act. In contrast, an adviser with a US place of business providing advisory services to an offshore client would be governed by all such provisions with respect to its entire business.

Interestingly, the SEC's course change on the Advisers Act's jurisdictional reach was based in part on the result of an examination of how the SEC has applied other federal securities laws and a consideration of "principals of comity" with other countries.[5] The SEC noted parallels in its use of a type of conduct-and-effects-test to determine whether the anti-fraud provisions of other securities laws should apply to extraterritorial activities. In addition, in adopting the approach, the SEC noted that the existence of securities regulations in foreign jurisdictions, coupled with the likely expectations of foreign investors that their dealings with an offshore adviser, albeit one registered in the United States, would not be subject to US regulation, supported the use of a conduct-and-effects test to improve the workings of international securities markets.[6]

The seminal *Unibanco* no-action letter represents the SEC Staff's most commonly cited use of its updated approach.[7] In *Unibanco*, the SEC sought to apply the conduct-and-effects test to a familiar scenario—the application of the Advisers Act to the unregistered offshore parent of a registered adviser subsidiary. *Unibanco* involved an unregistered foreign parent company and its offshore registered investment adviser subsidiary, which occasionally provided investment advice to US institutional investors. In agreeing not to require the parent company to register under the Advisers Act, the SEC also confirmed that, while the offshore subsidiary's US advisory business would be subject to the Advisers Act, the subsidiary's activities with respect to non-US clients would not, subject to certain conditions. The SEC imposed the following conditions: (a) the organizational existence of the parent and subsidiary must be separate; (b) the registered entity must be staffed with personnel "capable of providing investment advice;" (c) all personnel involved in US advisory activities must be deemed "associated persons" of the registered adviser; and (d) the SEC must be given access to the books and records and personnel involved in the US advisory business.[8] Requiring personnel to be associated persons and requiring access to the books and records provided the SEC with the access—or at least the right to access—it would not otherwise have to monitor the activities of an offshore adviser without subjecting the adviser to the requirements of the Advisers Act. If the SEC's goal was to maintain the ability to protect US investors while adopting the practical approach introduced in *Ellis*, the *Unibanco* letter may have been viewed by many as a success. However, even though offshore advisers were in a better position following the change than they were pre-1992, the course was still fraught with some uncertainty and over the years, the SEC issued a number of no-action letters to try to apply the requirements to a variety of specific factual circumstances presented to it by various offshore advisers.[9]

The situation was somewhat clearer for at least some of the offshore advisers—namely, the offshore fund managers without a significant number of separately managed accounts maintained for the benefit of US clients. This was because of the availability of the so-called "Private Adviser Exemption," codified in Section 203(b)(3) of the Advisers Act, which exempted any adviser from registration if the adviser had, during any 12-month period, less than 15 clients and did not hold itself out to the public as an investment adviser. Since under the Advisers Act an investment fund counted as a single client, regardless of how many investors it had, any adviser with less than 15 funds then under management was able to avoid registration. While this served as a safe harbor for a great number of fund managers, both foreign and domestic, it also

spared those advisers from having to undertake a substantive in-depth analysis of the application of the Advisers Act to their businesses. For example, it allowed the offshore fund managers with a presence in the United States (such as a place of business) to avoid having to consider the SEC's jurisdiction over their offshore activities under the *Unibanco* analysis described *supra*.

Questions remained, however, about the Advisers Act's extraterritorial reach for offshore advisers and fund managers who either could not avoid registration or, for one reason or another, decided to register voluntarily. Could these advisers still rely on the SEC's previous statements that the adviser's offshore activity would stay out of its reach, or were these advisers subjecting themselves to additional regulation by choosing to register or generally doing business in the United States or with US investors? Ironically, the SEC sought to clarify the answers to some of these questions after it attempted to neuter the Private Adviser Exemption.

In 2004, seeking to require managers of hedge funds and other private investment vehicles to register under the Advisers Act, the SEC adopted Rule 203(b)(3)-2, which mandated that a private fund adviser count each owner of a "private fund" toward the 14-client limit provided by the Private Adviser Exemption of Section 203(b)(3).[10] The effect of the new rule was to prevent any adviser to a private fund with more than 14 investors over the course of the preceding year from being able to claim the exemption. While the Rule required most advisers to private funds to register with the SEC, it surprisingly provided certain categories of offshore advisers with some of the clearest reprieve to date. In the release adopting Rule 203(b)(3)-2, the SEC noted that offshore advisers with a principal place of business outside the United States could still count offshore private funds they managed as the clients for purposes of determining the required scope of the advisers' compliance obligations under the Advisers Act. In other words, an offshore adviser to a private fund, with no direct US clients (US investors in the fund did not count), was still not required to register with the SEC. Further, if such an adviser undertook to so register (for example because in addition to offshore private funds, it also had US private funds or direct US clients, or perhaps because it had an office in the United States), it would generally need only to comply with certain books and records requirements under the Advisers Act and be subject to examination by the SEC, but would not need to comply with many other substantive provisions of the Advisers Act.

The concept of exempting offshore advisers from having to comply with substantive provisions of the Advisers Act has become known colloquially as "Adviser Lite" or "SEC Lite," and was most explicitly described in an advisory letter to the American Bar Association's Subcommittee on Private Investment Entities (the ABA Letter).[11] The impetus for the ABA Letter was a now-famous decision by the DC Circuit Court of Appeals that vacated the SEC's adoption of Rule 206(b)(3)-2 on the grounds that the means by which the SEC sought to require fund managers to register—by changing the definition of "client"—were improper.[12]

Following that Court of Appeals decision, the scope of the Private Adviser Exemption was restored, and many offshore advisers, particularly private fund managers, were once again no longer concerned with the prospect of having to register. However, since it had been nearly two years since the SEC's adoption of Rule 206(b)(3)-2, many private fund managers and other offshore advisers had already gone through the process of registering as investment advisers and were now considering whether to de-register in light of the *Goldstein* decision. The question presented to the SEC was whether the hands-off approach described in the 2004 rule release with respect to offshore advisers registered under the Advisers Act would survive. In the ABA Letter, the SEC re-affirmed its prior guidance by clarifying that registered offshore advisers would only be required to comply with the substantive provisions of the Advisers Act with respect to US clients—excluding US investors in a private fund. Accordingly, the SEC felt it was necessary to specifically re-endorse the adherence to "SEC Lite." Fast-forward to 2012, and as a result of the changes implementing the Dodd-Frank Act, the applicability of SEC Lite to offshore advisers has been made less certain,

leaving some to wonder whether it survives at all.

In the hopes that the SEC will once again re-affirm the SEC Lite approach, we will briefly describe what SEC Lite means for a registered offshore adviser. First, any registered adviser, including an offshore adviser relying on SEC Lite, must maintain certain books and records (including various corporate documents as well as client records, trading reports, etc.) relating to both its US and non-US clients, including to provide the SEC an opportunity to confirm that the adviser's US clients are treated fairly. The length of time for which an adviser must keep these records varies, but it is generally at least two years at the adviser's place of business and for up to five or six years in a place where the adviser may easily access such records. The SEC has also noted that under SEC Lite, all advisers must generally remain subject to examination by the SEC Staff, though the SEC had stated that it did not generally intend to conduct on-site examinations of offshore advisers.

In addition to the above described requirements, registered advisers are generally subject to a litany of other requirements, some of which, as we indicate below, were at least temporarily relaxed under SEC Lite with respect to offshore advisers.

Performance Fee Restrictions—Perhaps most relevant to offshore advisers, Rule 205-3 of the Advisers Act restricts registered investment advisers from charging US clients any fee based on a share of the profits of a fund or account, unless those clients are "qualified clients." The SEC recently updated the definition of "qualified client" to include clients who have either $1 million or more under management with the adviser (or invested in a fund) or have a net worth (excluding the value of the principal residence) of at least $2 million. The SEC indicated that under SEC Lite, offshore advisers would not be subject to performance fee restrictions with respect to their non-US clients.

Advertising Restrictions—Registered advisers are prohibited from distributing materially untrue or misleading advertisements. The SEC also prohibits registered advisers from using "testimonials," or client endorsements, in their advertising and significantly regulates advisers' use of performance presentations in advertisements. The SEC indicated that offshore advisers will not be subject to the specific advertising requirements with respect to their non-US clients.

Custody—Advisers to private funds are generally deemed to have custody of fund assets. In order to comply with the Advisers Act, advisers with custody must maintain such assets with a qualified custodian (which usually means a bank or broker-dealer) and comply with certain recordkeeping and disclosure requirements. The SEC indicated that offshore advisers will not be required to comply with the requirements of the custody rule with respect to the accounts of their non-US clients.

Compliance Program—Registered advisers must establish compliance policies and procedures, the administration of which must be carried out by a Chief Compliance Officer. The policies and procedures must generally be followed by all of the adviser's "associated persons." The SEC indicated that offshore advisers would not generally be required to have compliance policies and procedures or designate a Chief Compliance Officer to monitor them.

Code of Ethics—Registered advisers must adopt a code of ethics to which its associated persons must adhere. The code generally sets forth an adviser's fiduciary obligations and sets up a framework for the oversight of certain employees' personal securities trading, including the delivery of periodic trading reports and a process through which certain employees must obtain preclearance before effecting certain trades. The SEC indicated that offshore advisers relying on the SEC Lite are not required to maintain a code of ethics; however, they still need to ensure that they receive trading records of certain of their employees to monitor the violations of fiduciary duty obligations by such employees through for example, front-running their investors' accounts and other unlawful behavior.

Enter Dodd-Frank

As we noted above, beginning in 2011, the regulatory framework for offshore advisers (and domestic advisers too) underwent a major reconfiguration. The Dodd-Frank Act

introduced, among other things, significant changes to the requirements for registration for offshore managers—both of private funds and separately managed accounts. New rules adopted by the SEC on June 22, 2011, as required by the Dodd-Frank Act, crystallized the registration and regulatory requirements for offshore advisers beginning in 2012 and narrowed the exemptions from registration on which offshore advisers previously relied. The new exemptions—the "Private Fund Adviser Exemption" and "Foreign Private Adviser Exemption"—impact perhaps a large majority of offshore advisers and will subject many to registration under the Advisers Act and, to at least some extent, various reporting and regulatory requirements.

Foreign Private Adviser Exemption

Section 403 of the Dodd-Frank Act stripped away the oft-relied upon Private Adviser Exemption previously set forth in Section 203(b)(3) of the Advisers Act and replaced it with another exemption with a similar sounding name but a far more restrictive framework—the exemption for "foreign private advisers" (the Foreign Private Adviser Exemption). Under the Foreign Private Adviser Exemption—as with its predecessor—a foreign private adviser is exempt from the registration requirements of Section 203(a) and, thus, need not register or file any disclosure with the SEC, so long as it fits within the narrow exemption criteria.

Under Section 202(a)(30), a foreign private adviser is defined as any investment adviser that (1) has no place of business in the United States;[13] (2) has, in total, fewer than 15 clients in the United States (including investors in private funds advised by the adviser);[14] (3) has aggregate assets under management attributable to clients in the United States (including investors in private funds advised by the adviser) of less than $25 million and (4) does not hold itself out generally to the public in the United States as an investment adviser. The Foreign Private Adviser Exemption is not available to advisers to registered investment companies (that is, mutual funds) or business development companies.

While it has been assigned the statutory space previously occupied by the Private Adviser Exemption, and while it maintains some requirements from its predecessor (namely, a 14 client limit), the Foreign Private Adviser Exemption, with its low assets-under-management threshold and the new additional requirements relating to the place of business and counting investors in private funds rather than the private funds itself, eviscerates the exemption previously relied upon by so many offshore advisers and fund managers. Actual numbers may be difficult to determine (and the SEC did not, in its cost-benefit analysis, endeavor to estimate how many firms will fall within this exemption), but it is clear that a significant number of offshore advisers who previously relied on the Private Adviser Exemption will not qualify for the Foreign Private Adviser Exemption, most likely because they will exceed the assets-under-management limit. In addition, since reliance on the private adviser exemption was often an easy determination (if a firm managed fewer than 15 funds, the firm could generally rely on the Private Adviser Exemption), many offshore advisers have now been faced with having to make regulatory determinations that were previously unnecessary, most notably, a determination of whether investors in a private fund are US Persons or the permitted number of such investors, and a calculation of assets under management attributable to US Persons in general. For an offshore adviser who has never needed to consider these issues (at least not for the purpose of determining their registration status), this can be quite daunting.

Fortunately, for offshore advisers whose only clients in the United States are private funds or private fund investors, the Dodd-Frank Act provided for another exemption that is substantially less restrictive—though it comes with significantly more regulatory responsibilities.

Private Fund Adviser Exemption

In addition to the Foreign Private Adviser Exemption, the Dodd-Frank Act created a new Section 203(m) of the Advisers Act that now exempts "Private Fund Advisers" from registration (the Private Fund Adviser Exemption).

A Private Fund Adviser is one that (1) advises only qualifying private funds and (2) has assets under management in the United States of less than $150 million, in the aggregate. New Rule 203(m)-1 sets forth a framework for determining both (1) when assets are deemed to be managed in the United States, and (2) a total calculation of an adviser's assets under management for purposes of the exemption's $150 million assets-under-management limitation.

According to Rule 203(m)-1, a "qualifying private fund" generally includes any fund that qualifies for an exclusion from registration under Section 3 of the Investment Company Act of 1940 (the 1940 Act). This includes, but is not limited to, funds excluded from the 1940 Act registration pursuant to Sections 3(c)(1) (funds made up of up to 99 investors) and 3(c)(7) (funds made up of only "qualified purchasers").

As adopted, the Private Fund Adviser Exemption applies differently to an adviser with its principal office and place of business in the United States (US Fund Advisers) than it does to an adviser with a principal office and place of business outside the United States (Non-US Fund Advisers). While all of the clients of a US Fund Adviser must be qualifying private funds (that is, no separate accounts), a Non-US Fund Adviser has more flexibility. A Non-US Fund Adviser cannot have separate account clients that are "US persons" (as that term is defined in Regulation S under the Securities Act of 1933[15])—all US person clients must be qualifying private funds—but it may have other types of clients that are not US persons, so long as these clients' assets are not managed from a US place of business.

Perhaps the most important aspect of Rule 203(m)-1 for offshore advisers is its rules for calculating US assets under management. Non-US Fund Advisers have a distinct advantage over US Fund Advisers in that they get more flexibility in this calculation. Unlike a Non-US Fund Adviser, a US Fund Adviser must include all of its qualifying private funds' assets, including the assets of non-US private funds, in calculating its assets under management for purposes of the $150 million threshold. All of these assets are deemed to be managed from the United States. A Non-US Fund Adviser, however, only has to count toward the threshold the aggregate assets of its US qualifying private funds and other qualifying private fund assets that it manages from a "place of business" in the United States (whether US or non-US fund). Thus, a Non-US Adviser without a US place of business can accept an unlimited number of US investor investments into one or more non-US funds without being deemed to manage any amount in the United States for purposes of the assets-under-management threshold. This provides a strong rationale against an offshore adviser establishing a principal place of business or even an office in the US for the purpose of managing assets—especially for an offshore adviser that manages non-private fund assets.

Exempt Reporting Advisers

Thus, the Private Fund Adviser Exemption potentially preserves or, even improves the regulatory treatment of offshore advisers by codifying some of the SEC's positions previously expressed in the SEC no-action letters. Unfortunately, despite this new exemption, there are strings attached.

The SEC has designated certain advisers who are otherwise exempt from registration—specifically Private Fund Advisers and advisers to venture capital funds—as "Exempt Reporting Advisers." While these advisers are not required to submit to full SEC registration (which would require a complete Form ADV, completion and maintenance of a comprehensive compliance policy and manual, and subjection to potential SEC examination, among other requirements), Exempt Reporting Advisers are subject to various reporting and recordkeeping obligations and must also establish and abide by certain minimum policies and procedures. In other words, Exempt Reporting Advisers must still undertake a significant burden to satisfy the SEC's regulatory requirements.

New Rule 204-4 under the Advisers Act requires Exempt Reporting Advisers to submit and periodically update information on an amended version of Form ADV Part 1A, covering the following items—Item 1 (identifying information about the adviser); Item 2.B (the exemption on which the Exempt Reporting Adviser is relying in order to report, rather

than register, with the SEC); Item 3 (form of the adviser's corporate organization); Item 6 (the adviser's other business activities); Item 7 (other financial industry affiliations and information about the adviser's private funds, if any); Item 10 (the identity of and information about the adviser's control persons); Item 11 (the adviser's disciplinary history) and various sections of Schedules A, B, C and D that correspond to the adviser's answers to the above items. An Exempt Reporting Adviser must submit its initial Form ADV within 60 days of commencing to rely on the applicable exemption from registration.

The SEC has not identified how it will use the information it will collect as a result of these filing requirements, but it explained in its adopting release that the disclosure will assist it in determining whether the Exempt Reporting Adviser might present sufficient concerns to warrant the SEC's attention in order to protect clients, investors and other market participants. In addition, the SEC stated that the disclosure will also provide the public with basic information about the advisers and their businesses. The SEC is also using the exempt reporting adviser disclosures to generally collect information on private funds that it has long desired to have. Despite these clarifications, questions remain as to what the SEC, and the investing public, will really do with this information, particularly with respect to offshore advisers. Will the SEC use this information to initiate examinations of offshore advisers? Will it use the information as a quasi-examination, leading to greater use of its enforcement power against offshore advisers? For now, the SEC says it does not anticipate its Staff will conduct regular compliance examinations of Exempt Reporting Advisers, but once they start collecting this information, it would be hard to imagine that they would not make use of it.

Form PF

For advisers to private funds who register with the SEC, either voluntarily or because they have to do so, they will find that they are now required to disclose more than ever before. That is because, in addition to the information required to be disclosed on Form ADV, advisers to private funds now must complete the so-called Form PF, a lengthy and detailed report necessary to assist the Financial Stability Oversight Council (FSOC) in determining whether a fund presents systemic risks to the US financial system.[16] Advisers must file at least the first part of the Form PF if they (a) are registered or required to be registered as an investment adviser with the SEC, (b) advise one or more "private funds" and (3) had at least $150 million in assets under management attributable to private funds as of the end of the most recently completed fiscal year. The first part of the form includes census-type information about the private funds an adviser advises, including information about a fund's assets and liabilities, liquidity, derivatives positions, leverage, creditors, ownership and performance. The form also requires disclosure related to a fund's potential systemic exposure, including its investment strategy, the use of high-frequency trading, a fund's most significant credit counterparties and the use (or non-use) of central and bilateral trading and clearing mechanisms. Advisers with at least $1.5 billion in assets under management attributable to "hedge funds" as of the end of any month in a prior fiscal quarter (regardless of whether such assets are attributable to US clients) must also complete a second part of the form. This part of the form is aimed at collecting more specific data about the trading activities and risk of the hedge funds, including the amount of assets held in various securities classes, the turnover rate in those classes, geographical breakdown, and risk management techniques. In addition, there are separate sections to be completed for "liquidity funds" (essentially private money market funds) and private equity funds.

The SEC said that it will use the information it collects in Form PF to assist it with its examinations, investigations and other regulatory efforts with respect to private fund advisers. Unfortunately, registered offshore advisers are not exempt from the Form PF filing requirement,[17] though a non-US based Exempt Reporting Adviser qualifying under the private fund adviser exemption would be exempt, because they are also exempt from registration. Moreover, the offshore investment advisers qualifying for the Foreign

Private Adviser Exemption will not be subject to either requirement to file Form PF or be Exempt Reporting Advisers. However, to be able to avoid complying with both of these new fairly burdensome requirements in their entirety, the advisers must meet the conditions of the restrictive Foreign Private Adviser Exemption. Thus, an offshore adviser with fifteen or more clients in the United States (including investors in private funds advised by the adviser); OR aggregate assets under management attributable to clients in the United States (including investors in private funds advised by the adviser) of more than $25 million will generally become subject to the US regulatory disclosure regime by at the very least becoming an Exempt Reporting Adviser regardless of whether or not it desires to register with the SEC. Further, those advisers who register would also become subject to additional reporting requirements, such as Form PF; and it is yet unclear whether they will be able to take advantage of the SEC Lite regime described above previously applicable to them.

It also remains unclear how the SEC will monitor compliance with the new regulatory requirements by a wide range of offshore advisers that will now become Exempt Reporting Advisers, particularly in light of the SEC's budgetary constraints and its stated desire to focus on serving the interests of US investors. Finally, it remains unclear what effects the new requirements would have on the ability of US investors to invest with offshore advisers or to what extent these requirements, which are both costly and time-consuming would serve as a barrier to entry for such advisers into the United States. The effect of this could be damaging both from the adviser's perspective—it misses the opportunity to tap into the US market—and from the perspective of the US investor, who could benefit from investing with a particular offshore adviser. It is entirely possible that fear of being exposed may leave a certain category of offshore advisers; particularly those not already subject to a substantial regulatory disclosure regime in their home countries, completely out of the US market. What appears to be clear is that the SEC's new approach represents a significant departure from its 1992 position expressed in *Unibanco* to abstain from regulating offshore advisers whose conduct has not taken place in the US and has no effects on the US markets or their participants. Therefore, in the absence of any additional relief from the SEC, the offshore advisers doing any material amount of business in the United States should be prepared, in the worst case, for their entire business structures to be subjected to the full brunt of US regulation.

Notes

1. *Registration Under the Advisers Act of Certain Hedge Fund Advisers*, Investment Advisers Act Release No. 2333 (Dec. 2, 2004) at nn.188-190 (the Registration Release).

2. *See*, *e.g.*, the SEC's 1992 Report *Protecting Investors: A Half-Century of Investment Company Regulation.*

3. We summarize these substantive provisions in greater detail below.

4. Richard Ellis, Inc., SEC No-Action Letter (Sept. 17, 1981).

5. *See* Report at 229.

6. *Id.*

7. Uniao de Bancos de Brasileiros S.A., SEC No-Action Letter (July 28, 1992).

8. *Unibanco* Letter. The Staff also noted it based its decision on various undertakings made by the parent entity, namely that: (a) an agent for service of process would be appointed in the United States; (b) the books and records of the registered subsidiary would be kept in English and separate from the parent company's books and records; and (c) all persons involved in providing US advisory services would be considered associated persons of the registered subsidiary AND that the parent would agree to produce all personnel with experience or knowledge in the US advisory business in the event of a subpoena or request for information.

9. *See*, The National Mutual Group, SEC No-Action Letter (March 8, 1993); Mercury Asset Management plc, SEC No-Action Letter (April 16, 1993), Kleinwort Benson Investment Management Limited, SEC No-Action Letter (Dec. 15, 1993), and ABN AMRO Bank N.V., SEC No-Action Letter (July 1, 1997).

10. *See* Registration Release.

11. ABA Subcommittee on Private Investment Entities, SEC No-Action Letter (Aug. 10, 2006).

12. *See* Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

13. Rule 222-1 (a) of the Advisers Act defines "place of business" as (a) an office at which the investment adviser regularly provides investment advisory services, solicits, meets with, or otherwise communicates with clients, and (b) any other location that is held out to the general public

as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

14. For purposes of the Foreign Private Adviser Exemption, the SEC defines "in the United States" as (a) with respect to a place of business, any such place located in the "United States," as defined by Regulation S and (b) with respect to any client or private fund investor, any person who is a "US Person" under Regulation S, except any discretionary account held by a dealer or other professional fiduciary outside of the United States for the benefit of a "US Person" is a person "in the United States" if the dealer or fiduciary is a related person of the adviser relying on the exemption.

15. A "US person" under Regulation S includes, among other persons, natural persons resident in the United States and any partnership or corporation organized or incorporated under the laws of the United States.

16. *See* SEC Release No. IA-3308 (Oct. 31, 2011).

17. Although the SEC indicated that if an adviser's principal office and place of business are located outside the US, when reporting on Form PF, the adviser can disregard any private fund that, during the adviser's last fiscal year, was not a US person, was not offered in the US, and was not beneficially owned by any US person.

Authorization for US Managers under the AIFMD

By Stuart E. Fross and Michael J. Rohr

In our article appearing in the February 2012 issue of *The Investment Lawyer*, we reviewed the Alternative Investment Fund Managers Directive (AIFMD)[1] with an eye to identifying how a US investment adviser might determine the best strategy for adapting to the AIFMD.[2] In this Article, we assume that the investment adviser has decided to jump in with both feet, and make AIFMD a platform to raise money under management in Europe. This second article addresses how to do that.

By way of reminder, AIFMD establishes a comprehensive scheme for the marketing and distribution of Alternative Investment Funds (AIFs) by Alternative Investment Fund Managers (AIFMs) within the European Union (EU). On December 2, 2010, the European Commission sent a provisional request to the Committee of the European Securities Regulators, the precursor to the European Securities Market Authority (ESMA), seeking advice on implementing measures for the AIFMD. The provisional request was divided into four parts: Part I covers general provisions, authorization and operating conditions. Part II covers implementing measures regarding the depositary. Part III covers transparency requirements and leverage, and Part IV covers implementing measures regarding supervision. On November 16, 2011, ESMA issued its technical guidance to the European commission in the form of a "Final Report."[3] An analysis of this Final Report offers a clear view into what the Commission's regulations relating to AIFMD will look like.

There are three primary reasons why US money managers (US Managers) who manage non-EU alternative funds may want to prepare for authorization under and become compliant with the AIFMD. First, it is likely that national private placements will come to an end quite soon. That is, it is increasingly likely that the sale of Cayman funds (for example) to Europe will soon be precluded on a national private placement basis. There are two forces at work here; first current national private placement regimes will become unavailable to US Managers altogether in 2018 or 2019 (depending on whether the implementation calendar continues to slip). Second, it seems likely that country by country, national private placement regimes will be restricted, or precluded, either by regulation or market forces even before 2018/19.[4] The net result will be that US Managers who desire to market non-EU AIFs in the EU will simply have to do so under the AIFMD passporting regime, assuming, as we do, that the EU marketing passport is extended to non-EU AIFM after 2015. As such, many US Managers may want to anticipate the practical implications of authorization in order to be prepared to take advantage of the passporting regime as soon as it becomes available.[5]

With these considerations in mind, this article will focus on the conditions precedent to

Mr. Fross is a Partner, and Mr. Rohr is an Associate, in the Boston office of K&L Gates, LLP. This publication is for informational purposes and does not contain or convey legal advice. The information herein should not be used or relied on in regard to any particular facts or circumstances without consulting a lawyer.

US Managers becoming authorized to market non-EU AIFs in the EU under the AIFMD, as illuminated by the Final Report.[6]

Conditions Precedent to the Application

In order to become authorized to manage EU AIFs, or market non-EU AIFs in the EU under the passporting regime, a US Manager must (1) apply to an appropriate Member State of Reference (MSR) and become authorized; and (2) comply with the substantive provisions of the AIFMD in their entirety (excluding Chapter VI, which is specifically applicable to EU AIFMs).[7] As such, US Managers considering authorization must be aware of the substantive requirements of the AIFMD.

Determining the Appropriate Member State of Reference

Article 37(1) of the AIFMD requires a manager to be authorized by its MSR. This is quite straightforward at one level: a Luxembourg AIFM will be regulated by Luxembourg, of course. The MSR is not so obvious, however, for a US Manager. Article 37(4) provides the process for determining the MSR. A US Manager's MSR is determined as Set forth in the table below.

Box 113 of the Final Report[8] specifies a detailed procedure for determining Member State of Reference in cases of potential conflict between the competent authorities of several member states. It provides that the MSR is the "Member State where [an AIFM] intends to develop effective marketing for most of those AIFs," meaning the Member State where the AIFM intends to target investors by promoting and offering, including through third party distributors, most of its AIFs. Selection of the MSR will be based upon a non-exhaustive list of factors that should be considered:

(1) The member state where the distributors are going to promote the most units;
(2) The member state where most of the targeted investors are domiciled;
(3) The language of the offering/promotional documents; and
(4) Where the advertisements are most visible/frequent.

In the authors' experience, non-EU AIFs with institutional investment strategies have sold well in the Netherlands to pension schemes. Were a manager to market several of its funds exclusively in this way, then the Netherlands would be the US Manager's MSR.

Practice Note: For US Managers marketing non-EU AIFs, the MSR will be where the marketing of those funds is the most intensive. This effectively means that the more familiar fund domiciles of Ireland and Luxembourg are unlikely to serve as the MSR for US Managers.

Applying for Authorization and Becoming Authorized

NOTE—Each member state is likely to adopt its own specific application process for becoming authorized as an AIFM and for authorizing specific AIFs under the AIFMD, within the parameters set forth therein. As such, the following discussion attempts to outline the authorization process to the extent it is discussed in the AIFMD.

Pursuant to Articles 37(5) and (7) of the AIFMD, the MSR will require the US

US Manager Marketing:	**Determining MSR:**
Only one non-EU AIF in only one Member State.	The MSR in which the fund is marketed is that Member State (Article 37(4)(d)).
Only one non-EU AIF, but in different Member States.	The MSR is one of those Member States (Article 37(4)(f)).
Several non-EU AIFs.	The MSR is the Member State where the US Manager intends to develop effective marketing for most of the AIFs (Article 37(4)(h)).

Manager to submit an application for authorization and determine that the proposed MSR is the appropriate MSR based on the application. The MSR will also review the AIFM's marketing strategy and will notify ESMA to the effect that the MSR is the correct MSR. Further, certain administrative hurdles must be met. The US Manager must have appointed a legal representative in the MSR to serve as the contact person for the investors and authorities and to carry out compliance functions. Additionally, cooperation agreements must be in place between the MSR's authorities and the US Securities and Exchange Commission (SEC), and the United States must not be listed as a Non-Cooperative Country and Territory by the Financial Action Task Force. Last, the United States must have an agreement on the exchange of tax information with the MSR that fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention on Income and on Capital and ensures an effective exchange of information in tax matters.

The US Manager will also have to apply for authorization from its MSR to manage or market a particular AIF to professional investors within the EU. The administrative conditions, *supra*, with respect to the Manager's country must also be met with respect to the AIF's country (if the AIF is based in a third country). Also, Article 37(8) would require a US Manager to provide its MSR with detailed information (as required by Article 7(2) (the rules applicable to EU AIFMs) in addition to supplemental information specifically required by Article 37(8)).

The US Manager will be required to provide: information on the persons effectively conducting the business of the Manager; identification of the Manager's shareholders or members (whether direct or indirect, natural persons or entities) and the amounts of their holdings; a business plan setting out the Manager's organizational structure and how the Manager intends to comply with its obligations under the AIFMD; information on the Manager's remuneration policies and practices; and information on arrangements for delegation and/or sub-delegation to sub-advisers. In addition, Article 37(8) will require US Managers to provide the following: a justification as to why the Manager's selection of the MSR is appropriate, the name of the legal representative of the AIFM in its home state, and a list of all of the provisions of the AIFMD for which compliance is impossible due to conflicting provisions of another mandatory law (and evidence that the AIFM is subject to an equivalent standard of regulation in the United States with the same regulatory purposes and level of investor protection as that of the MSR).

Further, the US Manager must provide detailed fund-related information about the investment strategies of each fund marketed in the EU, the types of underlying funds if the AIF is a fund of funds, the AIFM's policy as regards the use of leverage, the risk profiles and other characteristics of the AIFs it manages or intends to manage, information about the Member States or third countries in which such AIFs are established or are expected to be established, information on where the master AIF is established if the AIF is a feeder AIF, the rules or instruments of incorporation of each AIF the AIFM intends to manage, and information on the arrangements made for the appointment of the depositary (that meets the requirements of the AIFMD) for each AIF the AIFM intends to manage.

Practice Note: Development of an AIFMD "business plan" can be expected to be a highly detailed process that will reach far beyond legal and regulatory requirements. The business plan will need to address, in detail, ongoing compliance with the AIFMD's substantive requirements.

Substantive Requirements of the AIFMD

Certain substantive requirements (Capital Requirements, Organizational Requirements, Risk Management, Securitizations and Cooperation Agreements) were discussed in detail in our prior article. Capital Requirements, Organizational Requirements and Risk Management are briefly summarized below, along with a more in-depth discussion of the other substantive requirements that the AIFMD imposes on US Managers (Operating Conditions, Portfolio Management

Conditions and Leverage, Liquidity Management Conditions, Conflicts of Interest and Remuneration Conditions, Valuation, and Delegation).

Capital Requirements. Article 9 of the AIFMD requires minimum initial capital (€125k for externally managed AIF), additional capital funds ("own funds") for funds exceeding €250m under management (0.02 percent of the amount exceeding €250m, up to but not greater than €10m in own funds), and "additional own funds" and/or indemnity insurance to cover the risks arising from professional negligence, taking into account the risks and quantitative requirements articulated in Boxes 5 and 7 of the Final Report, respectively. US Managers should calculate their capital requirements and accumulate capital as necessary before submitting an application for authorization to the relevant regulators in their MSR.

Organizational Requirements. The general organizational requirements for managers are set forth in Article 18 of the AIFMD, including administrative and accounting procedures, procedures for the protection of data, and rules related to personal trading and recordkeeping. In Boxes 44-52, ESMA's Final Report provides a comprehensive checklist of compliance responsibilities and a framework for administering a compliance program designed to minimize the risk of non-compliance. Most notably for US Managers, the Final Report holds senior management personally responsibility for administration of an effective compliance program.

Risk Management. Managers must have a functionally and hierarchically separate risk management function, including proper identification, measurement, management and monitoring of risks associated with each investment position. The risk profile of the AIF must correspond to the AIF's rules and its "size," including qualitative risk limits. Box 25 requires a manager to monitor risk limits and notify investors if an AIF's risk limits are exceeded. Further the manager must report to the board and senior management regarding any actual or foreseeable breaches of risk limits. Deciding to seek authorization will require some advisers to develop a risk function that is independent of operational areas and business units. Reporting lines and compensation arrangements should be revisited.

Practice Note: For senior management, the AIFMD is not a "set it and forget it" regime; the US Manager's senior management will be personally responsible for ongoing compliance in addition to their duties to supervise.

Operating Conditions (Implementing Measures on General Principles)

AIFMD Provisions on Operating Conditions. Article 12(1) of the AIFMD sets out general "conduct of business" principles, requiring that the US Manager (a) act with due care, diligence and fairly in the conduct of its affairs, (b) act in the best interests of the AIF, (c) have and employ necessary resources, (d) take all reasonable steps to avoid or address conflicts of interest that cannot be avoided (e) comply with "all regulatory requirements," and (f) treat all AIF investors fairly (that is, disclose all side letters).[9]

ESMA Technical Guidance on Operating Conditions. Box 10 contemplates that managers treat all AIF investors as "professional investors," similar to the approach taken in the Markets in Financial Instruments Directive (MiFID), when preparing conduct of business principles.[10] US Managers must have policies and procedures in place that are appropriate to prevent malpractices that might reasonably be expected to affect *the market's* stability and integrity. ESMA did not offer detailed examples of AIF malpractices that adversely affect the market, but cited late trading and market timing (associated with UCITS funds) as examples. Further, managers are responsible for ensuring that undue costs (such as excessive trading costs) are not charged to investors or to the AIF. Thus, it would appear that AIFs that follow very aggressive trading strategies may struggle to obtain authorization.

Portfolio Management Conditions

ESMA Technical Guidance on Due Diligence - Box 11 of ESMA's Technical Guidance requires managers to conduct "a high level of" investment due diligence and to preserve due diligence records for a period of four years. Specifically, this means that a manager must perform due diligence prior to acquisition of an asset, assessing all relevant legal, fiscal, financial or other "value-affecting factors," including exit strategies, and must

monitor its investments. Further a manager must have an AIF-specific "business plan" for *each* AIF that it manages that is consistent with the duration of the AIF's investments. Box 13 extends due diligence and prudence principles to counterparties and prime brokers, requiring senior management to prudently select and approve such parties prior to entering into an agreement and implying a duty to negotiate terms with the prime broker.

With respect to counterparties and prime brokers, Article 13 specifically mandates additional due diligence. Due diligence includes assuring that the prime broker is subject to "ongoing supervision" by a regulator. In addition, the US Manager will have to assess the prime broker's and counterparty's "financial soundness" and whether or not the firm has the "necessary organizational structure to supply the relevant services. Senior management of the AIFM must approve counterparties and prime brokers, and the AIFM must be able to demonstrate to its MSR regulator the basis for the selection of its counterparties and prime brokers.

ESMA Technical Guidance on Order Execution and Trade Allocation - ESMA sets forth criteria on order execution on a "best interest of the AIF" basis in Boxes 14-16, proposing a very detailed and prescriptive list of order execution criteria (that does not address soft dollars). Procedures are required for order handling, and to prevent misuse of information in all orders (for example, front running). Such criteria must be required to be reviewed annually on a "best execution" basis. The trade allocation rules start from a presumption against aggregation (Box 17). Aggregation is permitted if detailed conditions are met regarding measures to assure that aggregation will be "unlikely" to work to the disadvantage of any client "whose order is to be aggregated." Proprietary trades may be aggregated, but not in a way that "is detrimental to the AIF." This suggests that proprietary accounts may need to drop out of a block that is not a full order of all client demand for a security, and client accounts must have priority in getting filled. However, proportionate allocation across a block that includes proprietary accounts is permitted if necessary to get the trade done.[11]

AIFMD Provisions on Leverage. Article 25(3) of the AIFMD gives the Member State regulator the power to impose leverage limits on managers and other restrictions on the management of AIF to limit systemic risk. Article 4(1)(v) of the AIFMD defines leverage as any method by which AIFM increase exposure of a managed AIF (whether through cash or securities), or any leverage embedded through derivative positions. The Commission requested advice on the appropriate methods for calculating leverage and on methods by which an AIFM may increase the exposure of an AIF through leverage. AIFMs are also obliged to set maximum levels of leverage and make proper leverage disclosures to investors.

ESMA Implementing Measures on Leverage. Boxes 94-101 of the Final Report generally provide the methods for calculating leverage and for measuring the leverage associated with derivatives. Leverage must be calculated as a ratio of "exposure" to NAV, with "exposure" being calculated in accordance with either a "gross" method or a "commitment" method (unless the MSR permits an alternative to the commitment method, referred to as the advanced method). Under any method of calculation, exposure to third party collateral structures must be included to the extent that such exposure is specifically set up to increase the AIFs level of exposure. "Bridge" loans or other temporary borrowing arrangements may be excluded to the extent that such borrowings are "covered" by capital commitments (as defined in Box 94).

The gross method (Box 95) looks to the value of the AIF's assets and requires conversion of derivatives to their equivalent physical position (with the formulas for such conversion set forth in Box 99 by derivative type). The gross method also requires exclusion of cash and highly liquid cash equivalents, excludes netting and hedging and permits adjustment for repos/reverse repos. The commitment method (Box 96) is similar to the gross method except that it allows the AIFM to take into account netting and hedging arrangements that reduce exposure. The advanced method provides a highly-flexible alternative method for calculating leverage provided that the AIFM notifies its MSR and complies with the requirements set forth in Box 97, including the requirement that

such method of calculation is "fair, conservative and not underestimate or give a misleading view," and is applied consistently. Although ESMA expressly rejected calculation using the Value-at-Risk method, which was proposed in many responses to ESMA's draft technical advice and will be familiar to many US Managers, the flexibility afforded to AIFM in the advanced method may permit such calculation if the requirements in Box 97 are met, and if the MSR regulator is persuaded.

Box 101 of ESMA's Final Report provides the circumstances under which leverage limits may be imposed by the MSR regulator. Perhaps the key requirement is that the AIFM must demonstrate that the AIF's use of leverage is "reasonable" to the MSR regulator. Thus, the choice to passport within Europe may affect an AIF's leverage, and will put in the hands of the MSR regulator the ultimate authority to restrict leverage used by the AIF. Box 101 also provides that the MSR regulator is required to asses the risks of the use of leverage by an AIFM and the extent such use poses a systemic risk or could create disorderly markets. The regulator has the authority to intervene and impose leverage limits in the event of a downward spiral in prices of financial instruments.

Liquidity Management Conditions

Liquidity and redemption features. The AIFMD requires that managers "employ an appropriate liquidity management system and adopt procedures which enable them to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations." Liquidity management does not apply to closed-end AIFs. Article 16 of AIFMD requires stress testing to allow assessment of liquidity risk, in proportion to the AIF's redemption policy, management and investment strategy—all of which must be consistent. Further, pursuant to Article 23(4)(a), managers must periodically disclose to investors the percentage of AIF assets subject to "special arrangements" arising from their illiquid nature (defined in Box 31 of the ESMA's Final Report to include assets that have to be held in a side-pocket and other similar arrangements which achieve similar outcomes).

ESMA Technical Guidance on Liquidity Management. Pursuant to Box 32, a manager must be able to demonstrate to the relevant regulator that it has in place "appropriate and effective" liquidity management procedures.[12] Managers must monitor the liquidity of each AIF and adopt appropriate liquidity management policies that align investment strategy, liquidity profile and redemption policy.[13] Prospective investments must be analyzed using liquidity criteria and that prospective investment's contribution to the AIF's liquidity position. Qualitative and quantitative liquidity analysis is to be implemented and AIFMs are responsible for ensuring adequate disclosure of liquidity risk. Managers are further responsible for considering conflicts of interest between investors seeking to redeem, as well as any conflict associated with making an illiquid investment. Such liquidity management procedures must account for risk monitoring of liquidity and periodic stress testing that simulates a shortage of liquidity and atypical redemption requests, as well as valuation sensitivities, margin calls and other factors (Box 33). This testing should be as frequent as suggested by the redemption policy, strategy and holdings of the AIF (and at a minimum, annually).

Conflicts of Interest and Remuneration Conditions

To be in compliance, managers must have procedures in place designed to "identify, prevent, manage, monitor and disclose conflicts of interest." To the extent that the installed procedures are not sufficient to provide a reasonable degree of confidence in the prevention of any risk of damage to the investor's interest, the managers should disclose the general nature of the conflict to the investors.

Remuneration is a central tenet of the AIFMD, which contemplates controls applicable to remuneration paid to senior management, risk takers and control functions. A manager's remuneration policies should discourage risk-taking which is inconsistent with the risk profiles, fund rules, or instruments of incorporation of the AIF it manages. Further, a manager's remuneration policy should observe a multitude of requirements. Specific requirements include: (i) setting performance awards in a multi-year framework

suitable to the fund managed; (ii) limiting payment on early termination so as to not reward failure; (iii) risk adjusting performance awards to reflect all forms of current and future risks, and (iv) providing variable equity in line with long term interests.

AIFMD Provisions on Conflicts of Interest and Remuneration. Article 14 of the AIFMD requires managers to maintain and operate effective organizational controls "with a view to taking all reasonable steps" to identify, prevent, manage and monitor conflicts of interest so as to ensure no risk of damage to investors. All other conflicts must be disclosed.

ESMA Technical Guidance on Conflicts of Interest. Box 20 contemplates five inquiries a manager should undertake to identify possible conflicts: (a) any potential for gain/loss avoidance at an AIF's expense, (b) any interest in a service, activity or transaction distinct from that of AIF (for example, affiliated brokerage/underwriting), (c) any incentive to favor one client over another, (d) multiple clients receiving the same service, (e) receipt of any inducement in relation to managing the AIF from a third party other than standard fee for that service (for example, soft dollars).[14] Boxes 20-24 set forth ESMA's technical guidance on implementing conflict controls.

Box 21 requires a manager to have an effective, written, conflicts of interest policy. The key criterion is a process that identifies possible conflicts.

Box 22 sets out a series of steps designed to "wall off" fund management from other business interests of the manager and its relevant persons, including information barriers, separate supervision, removal of remuneration links, prevention of inappropriate influence, or sequential involvement in portfolio management, risk management or administration.

Box 23 calls for record keeping of types of activities and material conflicts arising from those activities, which must be disclosed, and which may be disclosed via a website, under certain circumstances.

Box 24 requires managers to have adequate strategies to ensure voting rights are exercised in the best interests of the AIF and investors (monitoring relevant corporate actions, consistency with investment objectives, preventing or managing conflicts) and to make those strategies available to investors on request.

Box 18 prohibits a manager from making any payment or receiving any monetary or non-monetary benefit related to portfolio management other than: (a) fees paid to the AIF, (b)(i) fees paid by the AIF that are fully disclosed and (b)(ii) the fee/payment is designed to enhance service quality,[15] or (c) proper fees to non-conflicted service providers. Fee disclosure may (initially) be summary. Box 18 is intended to address AIF marketing, and preclude inducements.

ESMA Technical Guidance on Remuneration. ESMA's Technical Guidance provides the required content and format of remuneration disclosures relating to aggregate compensation of senior management and staff that have a material impact on a fund's "risk profile" as part of an AIFM's annual reporting obligations. Essentially, the disclosure is limited to aggregate amounts paid in salary, and the amounts of variable compensation. It should be noted that the AIFMD has detailed substantive proscriptions regarding bonuses, requiring (in very general terms) that compensation of investment professionals be deferred, subject to claw backs, and convertible to stock in the manager at the manager's discretion.[16]

Valuation

The AIFMD focuses on independent valuation. Valuation can be performed either internally or externally, but the assurance of independence is key. If the valuation is performed internally, the valuation task must be "functionally independent" from the portfolio manager, remuneration policy, and anything else that might pose a conflict of interest. If valuation is performed externally, the manager maintains ultimate responsibility.

Practice Note: US Managers will need detailed due diligence files on investments and counter parties sufficient to satisfy the MSR regulator. In addition, the US Manager will have to test and report leverage and liquidity using methodologies acceptable to its MSR regulator.

AIFMD Provisions on Valuation. Article 19 of the AIFMD mandates that managers have "appropriate and consistent" valuation procedures that produce a "proper and independent valuation." Further, Article 19(3) requires

disclosure of NAV in accordance with AIF's rules (including redemption/sales cycles) and no less than yearly.

ESMA Technical Guidance on Valuation. Box 55 of ESMA's Final Report addresses the appropriate policies and procedures for asset valuation. These valuation policies and procedures must be in writing. They must address organizational structure, roles and responsibilities, including those of senior management, internal valuation independence safeguards, and coordination with external valuators. Importantly, a manager may not invest in a particular type of asset for the first time unless valuation methodologies have been identified for that asset. Boxes 56-61 provide detailed valuation models and methodology (which are beyond the scope of this article).

Delegation

The AIFMD puts into place certain procedures to be followed when a manager delegates one of its functions. The manager must notify the competent authorities of the MSR before delegating any function, and must be able to "objectively" justify the delegation. Risk and/or portfolio management functions may only be delegated to authorized and supervised "asset managers." Further, delegations to entities outside of the EU have additional requirements such as cooperation between the relevant supervisory authorities. Sub-delegation is also permitted with certain restrictions. The manager must consent prior to any sub-delegation and all conditions applicable to the initial delegation apply to the sub-delegate. Additionally, the relevant competent authority must be notified prior to the sub-delegation becoming effective.

AIFMD Provisions on Delegation. Article 20 of the AIFMD generally provides the rules for delegation of a manager's functions. It specifically requires the manager to notify their Member State authority prior to delegating tasks and sets out a series of conditions that must be met with respect to delegation of duties. Article 20(1)(a) requires an AIFM to be able to justify its entire delegation structure based on "objective reasons." Delegates must meet "resources" and "good repute" tests (set forth in Article 20(1)(b)), and delegation is only permissible to entities that are authorized/registered for "asset management" and subject to effective supervision (Article 20(1)(c)). Delegation is not permitted if it would prevent the effectiveness of supervision of the manager (Article 20(1)(e)), such as if it would prevent the manager from acting or AIF from being managed for the best interests of investors, and delegation may not be made to any entity whose interests are in conflict with the investors' interests unless there is functional and hierarchical segregation of the portfolio/risk tasks from the conflicting interests.

ESMA Technical Guidance on Delegation. Boxes 63 through 74 of ESMA's Final Report provide ESMA's Technical Guidance on delegation and sub-delegation. Pursuant to Box 63, the conditions of Article 20 must be met to delegate any task which is "critical or important for the proper performance" of services provided to an AIF. Critical or important services subject to Article 20 are ones where a failure would materially affect compliance. In order to provide objective reasons for delegation, as required by Article 20 of the AIFMD, ESMA's Final Rule requires managers to demonstrate that the delegation serves efficiency purposes (Box 65).[17] Objective reasons for delegating tasks include, but are not limited to, optimizing business processes, cost savings, expertise, and scalability.

Box 66 sets forth an AIFM's due diligence obligations for examining a potential delegate. This includes examination of resources, personnel (their theoretical knowledge and practical experience), and their "negative records" with respect to criminal, judicial or administrative proceedings.[18]

Box 69 discusses when a delegation would prevent the effective supervision of the AIFM so as to violate Article 20(1)(e). It mandates access to the delegate data by AIFM and authorities and delegate cooperation on inspection, and prohibits undisclosed conflicts between delegate and AIF.

Box 72 describes how the prohibition on delegating to an entity whose interests conflict with the investors' interests should work within an investment adviser: consideration of undue influence by members of a company group or by investors should

be considered. Also portfolio management must not perform "control tasks," and conversely risk managers must not perform "operational tasks" or be supervised by those that do. Risk and portfolio management must be independent at the adviser's board level.

Box 74 of ESMA's Final Report provides ESMA's technical guidance for when a manager would have delegated to the point of becoming a "letter box entity" in violation of Article 20(7)(b) of the AIFMD as: (1) if the AIFM can no longer effectively supervise and manage the risks of the delegated function or (2) the AIFM no longer has the "power to make decisions" in the areas required to be taken by "senior management."

***Practice Note*:** US Managers (particularly those that operate as managers of managers) will recognize that their appointment of sub-advisers will be deemed "delegation" and that US Managers that use sub-advisers will have to follow the procedures described above, effectively subjecting their sub-adviser appointment to MSR regulatory review, and, assuming no objection from the regulator, to ongoing compliance with the "do's" and "don'ts" list set out below. But, equally, US Managers may, upon reflection, prefer to be "delegates" themselves rather than Alternative Investment Fund Managers. We anticipate that "rent-a-management company" solutions will emerge for AIFM as they have for UCITS. We note a term "Super ManCo" is coming into use to describe UCITS management companies that intend to be qualified under the AIFMD to serve as the management company for AIFs.

Conclusion

US Managers may seek to become authorized as alternative investment fund managers to market alternative investment funds within the EU. Further, institutional investors in the EU may use the AIFMD as a "best practices" risk-management device and may expect even those managers marketing under national private placement rules to comply with many, if not all, of the substantive requirements of the AIFMD. As such, the AIFMD will affect any US Manager that seeks to manage money for EU clients in an alternative investment fund. The AIFMD's substantive requirements are formidable, turning a heretofore lightly regulated segment of the fund industry into arguably the most regulated of all kinds of collective investment vehicles. While the burdens of the AIFMD are not to be understated, authorized AIFMs will have a significant marketing advantage in Europe. Thus, access to Europe via the AIFMD may be an opportunity that is too significant not to embrace, even at the cost of the attendant regulation.

Do's and Don'ts of Delegation (Box 64)	
DO	**DO NOT**
Assure delegate complies and is effective.	Delegate senior management functions.
Retain resources to supervise delegate.	Alter management's obligations.
Assure for continuity in case delegation is terminated.	Undermine conditions for authorization.
Allocate responsibility clearly and in writing.	Contradict investment policy of AIF.
Instruct the delegated portfolio manager in implementation of investment policy.	
Assure delegate (i) keeps information confidential, (ii) discloses to AIFM any material adverse development, and (iii) has a business continuity plan.	

Notes

1. *European Parliament and Council Directive (EU) 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 105/2010.*

2. *See,* Stuart Fross and Michael Rohr, "AIFMD Implementing Regulations Update: ESMA's Final Report and Impacts for US Managers," *The Investment Lawyer,* Vol.19, No.2, Feb. 2012 (AIFMD Implementing Regulations Update). In our last article, six key themes were identified for US money managers seeking to adopt their current operations to AIFMD, focusing on (1) the AIFMD's "transparency" requirements for alternative investment funds (AIFs) organized outside the EU that will market in the EU on a national, private placement basis, and (2) certain of the AIFMD's most onerous requirements for US money managers.

3. *ESMA/2011/379, Final report: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive* (Final Report). These implementing measures are either "delegated acts" or "implementing measures." The delegated acts will (when adopted by the Commission) supplement the AIFMD text and (after a three-month review period for potential challenges by the Council or European Parliament) will then be followed by national legislation in the member states as part of implementation of the AIFMD on a country by country basis. Implementing measures are adopted by the Commission, subject to an internal review procedure. The Commission has (initially) until July 21, 2015 to complete the process of exercising its delegated authority, pursuant to AIFMD, Article 56. Member states are then obliged to adopt measure of national law that implement in national law the Commission's implementing measures.

4. *Id.* The AIFMD establishes new, "best-practices" for investor protections. As a result, US Managers may begin to experience social pressure from buyers seeking, in their fiduciary capacity, to ensure their money managers comply with the best-practices standards as soon as practically possible

5. By way of reminder, as of the effective date of AIFMD in July 2013, non-EU AIFMs managing non-EU AIFs are not required to be authorized if marketing in the EU under local private placement rules. However, the AIFMD's preamble contemplates that ESMA "should issue advice on the termination of those national [private placement] regimes." Such advice is expected in 2018. AIFMD, 174/13 at (90). For further discussion, please refer to S. Fross and M. Rohr, AIFMD Implementing Regulations Update, *supra* n.2.

6. This article is not addressed to the depositary requirements under the AIFMD and the Final Report.

7. *See* Article 37(1). Article 37(2) provides an exception for complying with a provision of the AIFMD "if and to the extent that compliance" is incompatible with another law that the US Manager is subject to, provided the Manager can demonstrate that simultaneous compliance with the AIFMD and a mandatory provision of the other law is impossible, and the other law has an "equivalent rule having the same regulatory purpose and the same level of protection" for investors as the AIFMD.

8. By way of reminder, ESMA reported its technical advice to the Commission by segregating background information and interpretive guidance from the actual technical guidance by placing the guidance in numbered "boxes."

9. Note the similarities to UCITS 14(1).

10. MiFID, among other things, imposes an obligation to determine the suitability of a fund for a particular client. Professional investors under MiFID can be assumed to be able to accept investment risk associated with a particular fund and to understand investment risks of that fund. Thus, the MiFID firm's duties are reduced to assuring that the investment objective of the fund meets the client's investment objective.

11. It seems that proprietary money will never be needed in a block trade and that Box 17, as a practical matter requires proprietary money to trade last.

12. Interestingly, the AIFM must give consideration not only to liquidity needs of investors, but also to those of "counterparties, creditors and third parties." ESMA specifically considers suspension of redemption rights—something only to be used when in "the best interests of all AIF Investors."

13. Funds of funds (if underlying funds are unlisted) must monitor the liquidity of the investments made by the underlying managers and their redemption policies.

14. In addressing AIFM conflicts, ESMA made reference to the November 2010 IOSCO Report on Private Equity Conflicts of Interest. ESMA provided an example: a conflict would be buying real estate from the AIFM or one of its relevant persons in a "bad location." Another interesting example of a conflict: AIF is long in an asset and a UCITS client shorts the same asset, particularly if the AIF is in a position to influence the price of that asset.

15. For example, where an investor pays subscription fees to an AIFM which are passed on to intermediaries for the marketing of the relevant AIF, the payment falls under paragraph (b) of Box 18. The inducement rules of Box 18 will be aligned with any future development of the MiFID rules.

16. For additional discussion of remuneration, see Stuart Fross and Philip Morgan, "The Advent of Investment Adviser Remuneration Regulation," *The Investment Lawyer,* Vol.18, No.7, July 2011, available at *www.klgates.com/files/...4049.../IL_0711_Fross_Morgan.pdf.*

17. The rule is based on the UCITS approach in Article 13 of the UCITS Directive.

18. Professional service providers established in the EU and authorized for the purposes of the delegated task are presumed to have no negative records unless facts suggest otherwise.

SEC Update
Willkie Farr & Gallagher LLP
Washington, DC

—By Benjamin J. Haskin
and David N. Solander

SEC Staff Permits Streamlined Registration for Some Investment Advisers

Following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act), Chairman of the Securities and Exchange Commission (the Commission) Mary Schapiro said, in adopting rules implementing the Act, that many "private fund advisers will now, not only register with the Commission, but be subject to its rules, its regulatory oversight and its examination program."[1] While the regulatory goal is to increase the oversight of private fund advisers, many questions were left unanswered by the new rules, including the appropriate burden-sharing among affiliated advisers and managers to hedge funds, private equity funds and other alternative investment vehicles that faced registration with the Commission as investment advisers under the Investment Advisers Act of 1940 (the Advisers Act).

The ABA's Request Letter

Fortunately for many of those managers, the Subcommittee on Hedge Funds of the American Bar Association—Business Law Section, sought to reduce the registration burdens and costs on private fund managers that have structured their advisory businesses as a collection of advisory entities and special purpose vehicles for a variety of legal, tax or liability reasons.[2] In particular, the Subcommittee focused on advisers with affiliates providing general partner or other services to advisory clients. The Subcommittee addressed a letter to the Commission's Division of Investment Management requesting the Division Staff's guidance on a number of issues affecting private fund advisers as many of those advisers sought to meet the Commission's March 30, 2012 deadline to be registered. In its letter, the Subcommittee requested that the Staff:

1. Confirm the Staff's prior guidance provided to the ABA Subcommittee on Private Investment Entities in a letter dated December 8, 2005 (the 2005 Staff Letter)[3] with respect to the treatment of certain special purpose vehicles (or SPVs) that act as general partner or managing member to a private fund;
2. Expand the Staff's prior guidance contained in the 2005 Staff Letter to include multiple SPVs of a registering adviser;
3. Expand the Staff's prior guidance with respect to SPVs contained in the 2005 Staff Letter to include SPVs of a registering adviser that may have directors that are not associated persons of that adviser; and
4. Provide a framework under which separate advisory entities in a control relationship and that conduct a single advisory business could register with the Commission through the registration of a single adviser.

The Staff's Response Letter

On January 18, 2012, leaving little time to spare before the Commission's deadline of February 14, 2012 for newly registering investment advisers to submit their initial Form ADVs, the Staff of the Division of Investment Management's Office of Investment Adviser Regulation responded to the Subcommittee's letter with positive and helpful guidance for many private fund advisers.[4]

Confirmation and Expansion of Existing Guidance

In response to the initial request regarding the status of SPVs acting as general partner or managing member, the Staff succinctly stated that "[t]he 2005 Staff Letter continues to represent the [S]taff's position." The Staff

reiterated the conditions set out in the 2005 Staff Letter under which an SPV could rely on the Staff's position not to recommend enforcement action to the Commission under Section 203(a) or Section 208(d) of the Advisers Act against a registered adviser and an SPV if the SPV did not separately register as an investment adviser, those conditions being that:

1. The investment adviser to a private fund establishes the SPV to act as the private fund's general partner or managing member;
2. The SPV's formation documents designate the investment adviser to manage the private fund's assets;
3. All of the investment advisory activities of the SPV are subject to the Advisers Act and the rules thereunder, and the SPV is subject to examination by the Commission; and
4. The registered adviser subjects the SPV, its employees and persons acting on its behalf to the registered adviser's supervision and control and, therefore, the SPV, all of its employees and the persons acting on its behalf are "persons associated with" the registered adviser (as defined in Section 202(a)(17) of the Advisers Act).

The Staff's response, while helpful in requiring only a single Form ADV to be completed for two separate entities, provides meaningful guidance only in very limited circumstances – a simple business structure in which one investment adviser owns the general partner or managing member of the private funds that it manages. Managers running their advisory business in a more complex structure featuring multiple management and advisory entities will receive very little direct guidance from the reiteration of positions in the 2005 Staff Letter.

Responding to the next two requests from the Subcommittee, the Staff expanded the position described above from the 2005 Staff Letter. The Staff permitted investment advisers that have created several SPVs as general partners or managing members to the private funds it manages to register with the Commission under a single registration. Additionally, in the case in which the SPVs have or employ directors independent of the investment adviser, and therefore not acting as "persons associated with" the investment adviser as required of all persons acting on behalf of the SPV under the 2005 Staff Letter, for a variety of legal and transactional reasons, the Staff agreed to not recommend enforcement actions if those SPVs do not separately register. The Staff stated that such an SPV must otherwise comply with the conditions in the 2005 Staff Letter except that the only persons acting on an SPV's behalf that the registered adviser does not supervise and control are directors (as defined in Section 202(a)(8) of the Advisers Act) who are independent of the registered adviser.

Umbrella Registration

The Staff's response to the Subcommittee's final request provided the most far reaching effects for investment managers to private funds registering with the Commission, yet still leaves the answers to some interpretive questions unclear. This response, which many in the investment management industry have termed "umbrella registration," generally permits investment managers in a control relationship with one another as part of the same advisory business to register a single US investment adviser pursuant to a registration that encompasses each of the other related advisers. The Staff deems the manager making the filing of Form ADV to be the "filing adviser" and those managers controlled by or under common control with the filing adviser and covered by the registration to be "relying advisers." The filing adviser must include certain information about all of the relying advisers in its Form ADV and the filing adviser and each relying adviser will be investment advisers registered with the Commission and, as such, each will be required to comply with all of the provisions of the Advisers Act and the rules thereunder that apply to registered advisers.

The Staff was careful to make a distinction between those advisers that are separately formed and conduct a single advisory business and those that are separately formed but conduct different advisory businesses. To clarify this distinction, the Staff set out the following circumstances involving a filing adviser and one or more relying advisers that, when all circumstances are met, the Staff would view

together as the conducting of a single advisory business:

1. The filing adviser and each relying adviser advise only private funds and separate account clients that are qualified clients (as defined in Advisers Act Rule 205-3) and are otherwise eligible to invest in the private funds advised by the filing adviser or a relying adviser and whose accounts pursue investment objectives and strategies that are substantially similar or otherwise related to those private funds;
2. Each relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control and, therefore, each relying adviser, its employees and the persons acting on its behalf are "persons associated with" the filing adviser (as defined in Section 202(a)(17) of the Advisers Act);
3. The filing adviser has its principal office and place of business in the United States and, therefore, all of the substantive provisions of the Advisers Act and the rules thereunder apply to the filing adviser's and each relying adviser's dealings with each of its clients, regardless of whether any client or the filing adviser or relying adviser providing the advice is a United States person;
4. The advisory activities of each relying adviser are subject to the Advisers Act and the rules thereunder, and each relying adviser is subject to examination by the Commission;
5. The filing adviser and each relying adviser operate under a single code of ethics adopted in accordance with Advisers Act Rule 204A-1 and a single set of written policies and procedures adopted and implemented in accordance with Advisers Act Rule 206(4)-(7) and administered by a single chief compliance officer in accordance with that rule; and
6. The filing adviser discloses in its Form ADV (Miscellaneous Section of Schedule D) that it and its relying advisers are together filing a single Form ADV in reliance on the position expressed in the Staff's letter and identifies each relying adviser by completing a separate Section 1.B., Schedule D, of Form ADV for each relying adviser and identifying it as such by including the notation "(relying adviser)."

Meeting these conditions, it would seem, will be sufficient to determine whether filing advisers and relying advisers are conducting a single advisory business and are eligible to rely on the Staff's guidance for making only a single registration for all of the relevant advisers. It is not clear, however, whether the Staff would take a view contrary to this position if the particular facts indicated a different type of advisory business yet each of the conditions set out above was met; for example, by an adviser focusing on long-term private equity investments and a related adviser focusing on short-term equity trading.

In the letter's footnotes, the Staff clarified that the filing adviser must be located in the United States because it perceived a potential for non-US managers to file as filing advisers together with US managers as relying advisers and claim that most of the substantive provisions of the Advisers Act should not be applied to the non-US clients of any of the US managers under the Staff's previously issued "registration lite" guidance for non-US registered investment advisers.[5] The implication of this position, and the Staff's statement that each relying adviser is subject to the entire Advisers Act, is that a non-US-based relying adviser is subject to all of the substantive provisions of the Advisers Act even with respect to its non-US clients and the position suggests that such a non-US-based adviser could avoid this outcome by simply registering separately. Further, adding the uncertainty of the guidance regarding a single advisory business described above, a non-US-based relying adviser that operated an entirely different investment advisory business for non-US clients may be subject to the Advisers Act with respect to that separate advisory business. At the Practicing Law Institute's "Investment Management Institute 2012" held on February 9, 2012, a Staff member indicated that the Staff is considering this issue and may provide additional guidance in the future for non-US managers.

The Staff's analysis and the policy behind the letter seem to readily apply in other Advisers Act contexts as well. The newly

created exemptions from registration for venture capital advisers and certain private fund advisers ("exempt reporting advisers") require those advisers to provide annual reporting to the Commission on Form ADV Part 1, although on only portions of the Form. Those advisers would seemingly face the same burdens and costs associated with reporting to the Commission if the advisers are part of a single advisory business and organized in a complex structure of separate entities for the various reasons as previously described. Exempt reporting advisers that could benefit from a similar approach face an initial reporting deadline of March 30, 2012. At the same PLI program noted above, a member of the Staff said that the Staff is considering similar guidance for exempt reporting advisers, but as of the time this column was written, no such guidance had been issued.

Notes

1 Speech available at *http://sec.gov/news/speech/2011/spch062211mls-items-1-2.htm.*

2 American Bar Association, Business Law Section, SEC No-Action Letter (Jan. 18, 2012), publicly available at *http://sec.gov/divisions/investment/noaction/2012/aba011812.htm*.

3 *See* American Bar Association Subcommittee on Private Investment Entities, SEC No-Action Letter (Dec. 8, 2005) at Question and Answer G.1.

4 *See supra* n.2. Tram N. Nguyen, Branch Chief of the Private Funds Branch, authored the letter on behalf of the Commission's Staff which set out a response to each of the Subcommittee's requests described above.

5 *See Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers,* Investment Advisers Act Release No. 3222 (June 22, 2011) at section II.D. (reaffirming prior positions of the Commission and its Staff subject to the Staff providing additional guidance in the future under the new private adviser registration rules).

Aspen Publishers
Investment Lawyer
Distribution Center
7201 McKinney Circle
Frederick, MD 21704

TIMELY REPORT

Please Expedite

April/9900528067

To subscribe, call 1-800-638-8437 or order online at www.aspenpublishers.com

- -

Fastest Way to Order: Fax Us Today (800) 901-9075 or Call Toll-Free (800) 638-8437

Mail To: **Aspen Publishers,** 7201 McKinney Circle, Frederick MD 21704

Subscription Reservation Card

❐ **Yes, please enter my one-year subscription to THE INVESTMENT LAWYER (12 issues) at $620.**

Method of Payment

$ ____________ Total Amount Due

❐ Check Enclosed (Payable to Aspen Publishers) ❐ Bill Me ❐ Visa ❐ Mastercard ❐ American Express

Account # ______________________ Expiration Date ____________Signature (Required)____________________

Firm Name ________________________________ AL&B Acct. # ______________________

Name ________________________________ Title ______________________

Street Address ____

City/State/Zip ____

Phone (___) ________________________________ Fax (___) ______________________

1. All publications orders are subject to state sales tax plus 8.5 percent shipping and handling. Journal subscriptions in New York are not subject to sales tax. 2. After examining the publication(s) for 30 days, if you are not completely satisfied for any reason, return the material(s) to Aspen Publishers with the invoice marked “cancel.” 3. All “bill to” orders are subject to acceptance by Publisher. 4. Prices are subject to change without notice.