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Chapter Five:
Investment Adviser Regulation

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Managers of private investment funds must analyze whether registration as an investment adviser is required at either the state or the federal level. As described in this chapter, the definition of an investment adviser is broad and will generally include any person or entity that advises funds regarding securities investments. The US securities laws that regulate investment advisers apply to both advisers that operate within the United States, as well as advisers that operate outside of the United States but have US clients.

This chapter will focus primarily on the regulation of investment advisers at the federal level in the United States. However, a separate layer of regulation exists at the state level. While registration at the federal level will pre-empt much of the substantive and procedural regulation at the state level, an exemption from federal registration does not exempt an adviser from state regulation. For this reason, many investment advisers who qualify for federal registration, but are eligible to rely on an exemption, will still choose to register federally. Separate from such administrative reasons for registering federally as an investment adviser, there may be compelling business reasons for such registration, including investor perception and the ability to attract and manage certain ERISA assets.

Who is an investment adviser?

People and entities that provide advisory services within the United States are governed on the federal level by the Investment Advisers Act of 1940, as amended (the Advisers Act). The Advisers Act broadly defines an investment adviser as 'any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.'[1] The SEC has taken an expansive view of this definition. For example, the SEC has interpreted this definition to include any advice given relating to securities in general, as opposed to specific securities, as well as advice relating to asset allocation among different investment vehicles. As a general matter, a manager of a private investment fund that invests in securities will fall within the definition.

Who must register as an investment adviser?

The Advisers Act presently requires that, absent an exemption from registration, investment advisers using means of interstate or international commerce touching the United States in their advisory business, must register with the SEC (or, as discussed below, with an appropriate US state).[2]

Private adviser exemption from registration

An important and much utilised exemption from federal registration under the Advisers Act is the 'private adviser' exemption, which provides that an investment adviser that, during the course of the preceding 12 months, has had fewer than 15 clients, and that does not hold itself out generally to the public as an investment adviser, is not required to register.[3]

Counting clients

A legal entity that receives investment advice based on its investment objectives rather than the individual investment objectives of its beneficial owners is counted as one client for the purposes of determining the number of clients an adviser has.[4] Thus, to the extent that an investment adviser advises a fund, the fund generally would count as one client regardless of the number of investors that have subscribed for interests in the fund.

For investment advisers that have their principal office and place of business in the United States, all clients, including non-US clients (eg, an investment fund organised outside of the United States), count toward the 15-client limit. However, for investment advisers that do not have their

principal office and place of business in the United States, only the US clients must be counted.[5] Thus, a non-US fund advised by a non-US investment adviser would not be considered a US client, even if interests in the fund are privately offered in the United States.

Holding out

The 'holding out' provision has been interpreted by the SEC very broadly, and includes virtually all advertising. However, participation by the investment adviser in a private offering of interests in a fund is generally not deemed to be 'holding out'.[6]

Exemption from registration under the Advisers Act excuses an investment adviser from certain procedural and substantive provisions of the Advisers Act. However, an exempt investment adviser remains subject to the anti-fraud provisions of the Advisers Act.

Anti-fraud section applies to unregistered advisers

Advisers that are exempt from registration should be aware that the anti-fraud section of the Advisers Act applies generally to even investment advisers that are exempt from registration. Exempt advisers, however, have more latitude in choosing how to comply with the anti-fraud section because they are not subject to the anti-fraud rules explained below that describe in detail how a registered adviser must comply with the anti-fraud section. The rules may, however, serve as helpful guidance for exempt advisers seeking to avoid anti-fraud liability.

Where to register as an investment adviser

The SEC has exclusive regulatory jurisdiction over the categories listed below of investment advisers and their 'supervised persons':

- investment advisers with at least $25 million of assets under management;
- investment advisers to SEC-registered investment companies;
- investment advisers located in states that do not presently register or regulate investment advisers and who are not exempt under the Advisers Act;
- investment advisers whose principal place of business is in a country other than the United States; and
- such additional advisers, or classes of advisers, as the SEC may provide by rule or exemptive order.

The Advisers Act defines a 'supervised person' as any partner, officer, director (or other person occupying a similar status or performing similar functions), or employee of an investment adviser, or other person who provides investment advice on behalf of the investment adviser and is subject to the supervision and control of the investment adviser'.[7]

The SEC has established five additional classes of investment advisers that may register with the SEC regardless of whether they meet the criteria listed above.[8] These include:

- nationally-recognised statistical rating organisations;
- investment advisers that control, are controlled by, or are under common control with, a registered adviser, provided their principal office and place of business and that of the registered adviser are the same;
- investment advisers that reasonably expect to be eligible for SEC registration within 120 days of filing their application;
- pension consultants that provide advice to certain employee benefit, government, and church plans with aggregate assets of at least $50 million; and
- investment advisers that otherwise would initially be required to register as an adviser in 30 or more states.

Absent falling into one of these categories, an investment adviser is not permitted to register with the SEC and, therefore, becomes subject to the substantive requirements of the several states.

The Advisers Act, however, limits a state's ability to require a non-federally registered investment adviser to register in that state where the investment adviser:

- does not have a place of business within the state; and
- had fewer than six clients who were residents of that state during the preceding 12-month period.[9]

Because regulation by the states is not uniform and typically subjects investment advisers to more onerous requirements, it is generally preferable to register with the SEC.

Although states are not permitted to substantively regulate federally-registered investment advisers, they may (and most do) require the receipt of notice filings, which generally are copies of all filings made with the SEC as well as certain forms consenting to jurisdiction.

Investment adviser representatives

Although state regulation of supervised persons of SEC-registered advisers is generally pre-empted, individual states retain the ability to 'license, register or otherwise qualify' any 'investment adviser representative' (IAR) who has a place of business in that state. An IAR is a person who is a supervised person of an investment adviser and has 'natural person' clients (other than 'excepted persons') that total more than 10% of its clients.[10] However, a supervised person who does not regularly deal with clients or provides only impersonal advice is not an IAR.

An 'excepted person' is a person who is deemed to be a 'qualified client' pursuant to Rule 205-3(d)(1) under the Advisers Act.[11] As described below, a 'qualified client' is a natural person who has, at the time immediately following the entering of the investment advisory contract, at least $750,000 under the management of the investment adviser, a natural person or a company that has a net worth of at least $1,500,000 at the time the contract is entered into, a 'qualified purchaser', or certain affiliates and employees of the adviser.

As a practical matter, because investors in private investment funds are often 'qualified clients' and therefore 'excepted persons', supervised persons of advisers that only provide investment advice to private investment funds will generally not be considered to be IARs. Therefore, they will not be subject to regulation by the states.

How to register as an investment adviser

To register as an investment adviser with the SEC, an applicant must complete and submit to the SEC a Form ADV. There are two parts to Form ADV. Part I provides the SEC with information about the corporate nature of the applicant, its officers and directors, and the size of its business. Part II requires disclosure of the background and business practices of the applicant.

Applicants must file Part I of Form ADV, along with the appropriate schedules, and pay a filing fee. Part II of Form ADV must be kept current and maintained in the adviser's files. The SEC's Internet-based filing system, known as the Investment Adviser Registration Depository (IARD), permits investment advisers to satisfy their filing obligations with state and federal regulators with a single electronic filing of Part I made over the Internet.

Within 45 days after an applicant files a complete Form ADV, the SEC is required to either grant the registration or begin proceedings to deny it. Prior to the conclusion of the registration period, the SEC may issue one or more rounds of comments to the applicant, to which the applicant generally responds with requested changes to the application, additional information and clarification. This process does not typically affect the timing of the registration becoming effective.

Requirements applicable to registered investment advisers

Several reporting, record-keeping, and substantive requirements are imposed upon investment advisers that are registered with the SEC. The most significant of these requirements are summarised below.

Anti-fraud requirements

The Advisers Act generally provides that mis-statements or misleading omissions of material facts and other fraudulent acts and practices in connection with the conduct of an investment advisory business are prohibited.[12] This concept is particularly relevant with respect to the following areas:

Investment adviser advertising

Federally-registered advisers are generally prohibited from using any advertisement that contains any untrue statement of material fact or that is otherwise misleading.[13] The rule broadly defines an 'advertisement' to include any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, that offers any investment advisory service. In addition to the general prohibition, the Advisers Act specifically prohibits:

- the use of testimonials;
- reference to any past, specific recommendations made by the adviser that were profitable, unless the advertisement sets out a list of all recommendations made by the adviser within the preceding period of not less than one year;
- any representation that any formula or other device can be used to make investment decisions without disclosing prominently the limitations and difficulties with respect to its use; and
- any representation that any report, analysis, or other service will be provided without charge unless the report, analysis, or other service will be provided without any obligation whatsoever.

Restriction on payment of referral fees

Federally-registered investment advisers are generally prohibited from paying cash fees, directly or indirectly, to third parties for referring advisory clients to the adviser without satisfying conditions designed to ensure that clients are aware of the arrangements and payments.[14] These procedures may need to be complied with where a third party solicits individuals or entities to an investment adviser

who then may discuss whether investment in a particular fund managed by the adviser is appropriate.

Suitability of investments
The staff of the SEC has interpreted the Advisers Act to impose on federally-registered investment advisers a fiduciary duty to provide only suitable investment advice to their clients.[15] Generally, an adviser must inquire into a client's financial situation, investment experience, and investment objectives before recommending any securities. The subscription document used by private investment funds will generally include questions and representations that address these issues.

Fiduciary duty to investors
The SEC recently proposed a rule that would make it a fraudulent act for an adviser to any pooled investment vehicle to make false or misleading statements or to otherwise defraud investors or prospective investors in that vehicle. If adopted, this requirement would apply to registered investment advisers as well as those exempt from registration.[16]

Disclosure requirements
The Advisers Act generally requires every federally-registered investment adviser to deliver to each prospective advisory client a written disclosure statement (a brochure) describing the adviser's business practices and educational and business background.[17] The brochure is either a copy of Part II of Form ADV or a document containing equivalent information. This brochure must be delivered to the client either:

- at least 48 hours before entering into any written or oral contract for the provision of investment advice with a client; or
- at the time of entering into a contract with a client, if the contract permits the client to terminate the contract without penalty within five business days after entering into it.

The investment adviser is also required to offer to deliver an updated brochure to its existing clients, on an annual basis, without charge.

Historically, many practitioners were comfortable with the position that, where an investment adviser provides services to a private investment fund, the fund is considered the client and, therefore, the brochure is not required to be provided to investors in the fund. However, in recently proposed amendments to Form ADV, the SEC has indicated that it will view investors in the fund as investment adviser clients for purposes of the brochure delivery rules. Therefore, it may be advisable that the brochure be initially delivered to each fund investor and, in any case, should be made available upon request by any such investor.

The Advisers Act also requires:

- prompt disclosure of any legal or disciplinary event that is material to an evaluation of the adviser's integrity or its ability to meet its commitments to its clients;[18]
- disclosure to clients regarding the adviser's compensation; and
- disclosure of all potential conflicts of interest between the adviser and its clients.

The purpose of the Advisers Act disclosure requirement is to allow potential clients to assess whether the investment adviser's judgment is affected by situations in which there is a conflict of interest. This information would typically be included in the investment adviser's brochure.

Proxy voting policies and procedures
The rules relating to proxy voting require a registered investment adviser, with voting authority over client securities, to adopt written polices and procedures reasonably designed to ensure that the adviser votes proxies in the best interest of clients.[19] The rules also require that advisers: (i) disclose information to clients about the required policies and procedures; (ii) disclose to clients how they may obtain information on how the adviser voted their proxies; and (iii) maintain certain records related to proxy voting. The rules were adopted in an effort to ensure that registered investment advisers satisfy their fiduciary obligations to their clients and avoid material conflicts of interest in voting proxies.

Investment advisory contracts
The Advisers Act sets forth certain criteria that any investment advisory contract entered into by a federally-registered investment adviser must meet.[20] No registered investment adviser may enter into an advisory contract that fails to provide, in substance, that:

- no assignment of such contract shall be made by the investment adviser without the consent of the other party; and
- the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after the change.

Performance-based fees
In addition, the Advisers Act requires that, except as discussed below, a registered investment adviser may not enter into an investment advisory contract with a US resident

that provides for compensation to the investment adviser on the basis of a share of capital gains upon, or capital appreciation of, the funds or any portion of the funds of the client (ie, a performance-based fee).

The Advisers Act specifically exempts from the prohibition an investment advisory contract that is entered into with, among others: (a) a person who is not a resident of the United States; and (b) a private investment fund that is relying on the exemption provided by Section 3(c)(7) of the Investment Company Act of 1940, as amended (the Investment Company Act). In addition, the Advisers Act specifically permits a fulcrum fee, where a fee increases or decreases proportionately over a specified period of time with the performance of the funds under management in relation to the performance of an appropriate index.[21]

The SEC has, however, provided that a performance-based fee may be charged to a client which is a 'qualified client'.[22] A 'qualified client' is defined as a natural person who has, at the time immediately following the entering of the investment advisory contract, at least $750,000 under the management of the investment adviser, a natural person or a company that has a net worth of at least $1,500,000 at the time the contract is entered into, a 'qualified purchaser', as defined in the Investment Company Act, or certain affiliates and employees of the adviser.

Each investor in a private investment fund that is relying on the exemption from registration as an investment company provided by Section 3(c)(1) of the Investment Company Act is deemed to be a client of the investment adviser for purposes of the performance fee restriction.[23] Therefore, each investor in the fund generally must separately meet the definition of a 'qualified client' in order for the fund to be charged a performance fee.

Custody of client assets

Although federally-registered investment advisers are not prohibited from having custody of client assets, the SEC has imposed significant regulation on the practice.[24] In addition, many states place restrictions on an adviser's ability to have custody of client assets.

The custody rule defines 'custody' as 'holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them'.[25] According to the rule, an investment adviser has custody of client assets when it has possession or control of client funds or securities, the authority to withdraw funds, or legal ownership of or access to client funds or securities. With limited exceptions, investment advisers having custody of client funds and securities must maintain such assets with 'qualified custodians'. 'Qualified custodians' include banks and savings associations, broker-dealers, futures commission merchants, and foreign financial institutions that customarily hold financial assets for customers, provided that the foreign financial institution maintains client assets in customer accounts segregated from proprietary assets.

Investment advisers are required to send out quarterly account statements to clients. The quarterly statements must identify all funds and securities in the account at the end of the period, must set forth all account transactions during the period and may be delivered electronically. Investment advisers are not required to send quarterly account statements directly to clients if the advisers have a reasonable basis for believing that clients receive quarterly account statements directly from a qualified custodian. Clients not wishing to receive account statements may appoint an independent representative to receive their account statements. Investment advisers who choose to send the required quarterly account statements themselves, rather than relying on the custodian, are subject to an annual surprise audit.

Books and records requirements

Federally-registered investment advisers are required to maintain and preserve specified books and records and to make them accessible to SEC examiners for inspection (see the discussion on SEC examinations, below).[26] Most significantly, as part of these requirements, the SEC requires investment advisers to:

- retain copies of all advertisements and other communications that the adviser has circulated, directly or indirectly, to 10 or more people;[27] and
- maintain personal transaction reports with respect to certain personnel of the adviser.[28]

In addition, among other items, the retention of several other types of books and records is required, including:

Accounting records

- Journals, including cash receipts and disbursement records, and any other records of original entry forming the basis of entries in any ledger.
- General and auxiliary ledgers reflecting asset, liability, reserve, capital, income and expense accounts.
- All check books, bank statements, cancelled checks and cash reconciliations of the investment adviser.
- All bills or statements, paid or unpaid, relating to the business of the investment adviser.

- All trial balances, financial statements and internal audit working papers relating to the business of the investment adviser.

Records relating to advisory business and relations with clients

- Originals of all written communications received and copies of all written communications sent by the investment adviser relating to:
  - any recommendation made or proposed to be made and any advice given or proposed to be given;
  - any receipt, disbursement, or delivery of funds or securities; or
  - the placing or execution of any order to purchase or sell any security.

- A memorandum of each order given by the investment adviser for the purchase or sale of any security, or any instruction received by the investment adviser from the client concerning the purchase, sale, receipt or delivery of a particular security, and any modification or cancellation of any order or instruction.

- All written agreements entered into by the investment adviser with any client or otherwise relating to the business of the investment adviser.

- A copy of each brochure and a record of the dates that each brochure, and each amendment or revision thereof, was given, or offered to be given, to any client or prospective client who subsequently becomes a client.

The books and records that are required to be maintained must be kept for a period of five years (during the first two years, in an easily accessible place).[29] With respect to performance advertisements, the five-year period does not begin to run until the end of the fiscal year during which the investment adviser last published or otherwise disseminated the communication.[30]

Duty of supervision and insider trading procedures

The Advisers Act requires investment advisers to establish, maintain, and enforce written policies and procedures reasonably designed to prevent the misuse of material, non-public information by the investment adviser or any of its associated persons.[31] In addition, investment advisers have a duty to supervise all persons associated with the investment adviser with respect to activities performed on the adviser's behalf.[32]

Each investment adviser registered with the SEC must adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review those policies and procedures at least annually for adequacy and effective implementation, and designate a chief compliance officer (CCO) to be responsible for administering them.[33]

Code of ethics

Registered investment advisers must adopt, maintain and enforce codes of ethics.[34] Under the rule, an adviser's code of ethics must, at a minimum, contain provisions addressing each of the following:

- Standards of conduct and compliance with federal securities laws. The code must set forth a standard of business conduct that the adviser requires of all its supervised persons. The rule does not require the adviser to adopt a particular standard, but the standard chosen must reflect the adviser's fiduciary obligations and those of its supervised persons, and must require compliance with federal securities laws.

- Personal securities trading. The code must require an adviser's 'access persons' to provide an initial and annual holdings report of all 'reportable securities' in which the access person has any direct or indirect beneficial ownership and a quarterly report on their personal securities transactions in such reportable securities to the adviser's CCO or other designated persons. In addition to information on reportable securities, the initial and annual holdings report must also contain the name of any broker, dealer or bank with which the access person maintains an account in which any securities are held for the access person's direct or indirect benefit. The code must also require the adviser to review those reports. The initial report must be provided within 10 days of the person becoming an access person and annually thereafter, and must be current as of a date no more than 45 days prior to the date the person becomes an access person or the date the report was submitted in the case of the annual report. The quarterly report must be provided no later than 30 days after the end of each calendar quarter.

- Initial public offerings and limited offerings. The code must require that access persons obtain the adviser's approval before investing in an initial public offering or limited offering.

- Reporting violations. The code must require prompt internal reporting of any violations of the adviser's code to the adviser's chief compliance officer or other designated persons.

- Educating employees about the code and employee acknowledgement. The code must require the adviser to provide each supervised person with a copy of the code and any amendments. The code must also require each supervised person to acknowledge, in writing, his or her receipt of such copies.

Compliance by certain offshore advisers

Registered advisers with a principal office and place of business outside the US that advise private funds organized and incorporated outside the US but have no direct US clients, are not subject to the substantive provisions of the Advisers Act with respect to the offshore funds. Under the so-called 'Regulation Lite' regime, offshore advisers must comply with the requirements relating to the filing and maintenance of Form ADV, the maintenance of certain records, and the anti-fraud provisions of the Advisers Act, and remain subject to inspection by SEC examiners.[35]

SEC inspections

All investment advisers that are registered with the SEC are subject to SEC inspections which the SEC performs pursuant to its authority to examine an adviser's books and records under the Advisers Act.[36]

During these inspections, staff members of the SEC may be physically present at the offices of the investment adviser to review the adviser's books, records, policies and general compliance with SEC regulation. Depending on the completeness of the adviser's books and records, the nature of the business, the level of overall compliance, and the scope of the examination, the examination can last from two days to several weeks.

The SEC's goal is to examine every newly-registered investment adviser within one year of registration, although the first examination may take place within six months after registration. After the first examination, the SEC generally conducts an examination at least once every four years.

Privacy concerns

Regulation S-P was adopted by the SEC to address certain privacy concerns. Broadly speaking, Regulation S-P imposes on federally-registered investment advisers, among others, an affirmative and continuing obligation to maintain the confidentiality and protect the security of their clients' non-public personal information. In summary, the rule:

- requires registered investment advisers to notify clients of their privacy policies and practices;
- limits arrangements under which they may disclose non-public personal information about clients to non-affiliated third parties; and
- provides a means for clients to prevent the disclosure of non-public personal information to certain non-affiliated third parties by 'opting out' of such an arrangement, subject to a variety of exceptions.

For most investment advisers who do not share their clients' non-public information with non-affiliated third parties, the requirements of Regulation S-P are not overly burdensome, but do require that clients receive a written policy statement regarding the protection of such information initially upon the establishment of the customer relationship, and annually thereafter.

Endnotes:

1. Advisers Act Section 202(a)(11).
2. Advisers Act Section 203(a).
3. Advisers Act Section 203(b)(3).
4. Rule 203(b)(3)-1(a)(2)(i) under the Advisers Act. In 2004, the SEC amended the rule to require advisers to 'look through' private funds to count the investors in a fund as clients of the adviser for purposes of determining the number of 'clients'. See 69 Fed. Reg. 72, 054 (10 December 2004). This amendment to the rule was subsequently invalidated, and is no longer in effect. See Goldstein et al. v. SEC, No. 04-1434, 2006 (D.C. Cir. 23 June 2006).
5. Rule 203(b)(3)-1(b)(5) under the Advisers Act.
6. Rule 203(b)(3)-1(c) under the Advisers Act.
7. Advisers Act Section 202(a)(25).
8. Rule 203A-2 under the Advisers Act.
9. Advisers Act Section 222(d).
10. Advisers Act Rule 203A-3(a).
11. Rule 203A-3(a)(3) under the Advisers Act.
12. Advisers Act Section 206.
13. Rule 206(4)-1 under the Advisers Act.
14. Rule 206(4)-3 under the Advisers Act.

15. Investment Advisers Act Release No. 1406 (16 March 1994).

16. See Investment Advisers Act Release No. 2576 (27 December 2006).

17. Rule 204-3 under the Advisers Act.

18. Rule 206(4)-4 under the Advisers Act.

19. Rule 206(4)-6 under the Advisers Act.

20. Advisers Act Section 205.

21. Advisers Act Section 205(b).

22. Rule 205-3 under the Advisers Act.

23. Rule 205-3(b) under the Advisers Act.

24. Advisers Act Section 205.

25. Rule 206(4)-2 under the Advisers Act.

26. Rule 204-2 under the Advisers Act.

27. Rule 204-2(a)(11) under the Advisers Act.

28. Rules 204-2(a)(12) and (13) under the Advisers Act.

29. Rule 204-2(e)(1) under the Advisers Act.

30. Rule 204-2(e)(3) under the Advisers Act.

31. Advisers Act Section 204A.

32. Advisers Act Section 203(e)(6).

33. Rule 206(4)-7 under the Advisers Act.

34. Rule 204A-1 under the Advisers Act.

35. American Bar Association Subcommittee on Private Investment Entities, SEC No-Action letter (pub. avail. 10 August 2006).

36. Advisers Act Section 204.