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When Is an Investment Adviser a Broker-Dealer?

For a non-US money manager, marketing its services and products to US investors raises issues under the US securities laws, federal and state. One statute that is overlooked, but plays a significant role, is the Securities Exchange Act of 1934. How this statute, in particular, the broker-dealer registration provisions, applies to a non-US money manager seeking US funds is the subject of this article. We survey the registration requirements of this statute and suggest some options by which a non-US money manager may engage in these activities without having to register as a broker-dealer under this act.

by **Mark Berman**

In preparing for 2008, financial services industry practitioners will look back with interest on many developments that shaped the markets in 2007. They

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include the first stages of the global sub-prime/credit crisis, the adoption of rules by the Securities and Exchange Commission (SEC) for foreign issuer deregistration, guidance for management for its assessment of internal control over financial reporting and the roadmap to end IFRS-US GAAP reconciliations, and the EU Markets in Financial Instruments Directive (MiFID). During 2007, and despite the impact of the sub-prime/credit crisis, the pace of growth in cross-border investments, investment management and advisory activity has continued.

US investors, institutional and individual, continue to buy shares of non-US companies. The issuers of these securities are foreign private issuers with a class of securities and/or American Depositary Receipts registered with the SEC under Section 12 of the Securities Exchange Act of 1934 (Exchange Act), non-US companies that furnish information under Rule 12g3-2(b), the "information supplying exemption," non-US issuers of securities placed with qualified institutional buyers (QIBs) in re-sales effected under Rule 144A under the Securities Act of 1933 (Securities Act) and non-US companies whose securities are accessible only on or through non-US markets. This list also includes non-US non-SEC registered funds, hedge funds and funds of hedge funds (collectively referred to as non-US funds and hedge funds).

US investors have several avenues through which they can seek such investments. They can obtain advice from and effect transactions with US-based,

SEC registered broker-dealers. They can buy securities through the Internet. They can access these non-US securities through non-US banks, brokers and dealers (non-US firms) that must, absent an exemption or exception such as Exchange Act Rule 15a-6, register with the SEC under Section 15(b) of the Exchange Act. US persons may place their funds with US-based, SEC registered investment advisers for them to invest on their behalf in the non-US markets. US investors also can seek out non-US investment advisers (non-US money managers) to take advantage of their advisory and discretionary investment management services or to place funds with them to invest in the securities of non-US funds and hedge funds.

The competition among non-US money managers for US assets is fierce. To help gain an advantage over their peers, some non-US money managers register with the SEC as investment advisers under the Investment Advisers Act of 1940 (Advisers Act). Others do not register, but enter the US markets as sub-advisers to SEC registered investment advisers or as participating affiliates of SEC registered investment advisers. Still others eschew SEC registration and, since Advisers Act Rule 203(b)(3)-2 and other rule amendments requiring Advisers Act registration for advisers of private funds were vacated by *Goldstein v. SEC*,¹ take US money by having US investors invest in non-US funds and hedge funds. (These non-US money managers remain below the 15-person threshold for registration in the Advisers Act² but, because they are not SEC registered, become subject to state registration requirements.)

How does a non-US money manager market its services and the non-US funds and hedge funds that it manages to US persons? The obvious avenues are its Web site, the Internet (sending emails), the telephone, fax, the use of the post (mail) or personal visits. Each of these, according to provisions of the US federal securities laws and SEC positions, involve the “means of interstate commerce.”³ It is also open to a non-US money manager to engage others to market its services. There is the indirect route, which involves gaining access to the portfolio of a US investor through a non-affiliated investment adviser (as a sub-adviser) or an affiliate (as a participating affiliate).

A non-US money manager that offers its advisory and discretionary investment management services to US persons would be using the means of interstate commerce and subject to the registration provisions of the Advisers Act. It also would be subject to the anti-fraud provisions of that act and the other US securities laws. An issue also arises when a non-US money manager, whether or not in connection with its advisory or discretionary investment management services, holds itself out as being amenable to execute transactions in securities for US persons for which it would receive transaction-based compensation, and did this, or solicits US persons to invest in the securities of a non-US fund or hedge fund for whom it manages the portfolio. Doing this would bring into play the broker-dealer registration requirements of the Exchange Act.

Broker-Dealer Registration

The registration provisions of the Exchange Act apply to any person that engages in an activity that would bring it within the definitions of the terms a “broker” or “dealer.” A “broker” is defined in Section 3(a)(4) of the Exchange Act as a person that is engaged in the business of effecting transactions in securities for the account of others. A “dealer” is defined in Section 3(a)(5) of the Exchange Act as any person that buys or sells securities for its own account or for others.⁴ Neither of these terms is defined in terms of jurisdictional limits, but contemplates a specific activity.

The SEC defines the term “solicitation” broadly as any affirmative effort by a non-firm that induces or is intended to induce transactional business or develop an ongoing relationship for that non-US firm or for its affiliates.⁵

A non-US firm that conducts its activities totally outside the United States, adopts protective measures regarding its Web site to prevent US persons from doing business with it and does not solicit US persons would not be required to register as a broker-dealer.⁶ However, a communication by a non-US firm into the United States that is intended to have a US person open an account or buy securities would be a solicitation using the means of interstate commerce and implicate Exchange Act broker-dealer registration.

Non-US firms rely on Exchange Act Rule 15a-6 to avoid registration with the SEC as a broker-dealer. Rule 15a-6 is a non-exclusive safe harbor that permits certain US institutional investors to gain access to foreign markets, research and securities through non-US firms. A non-US firm can, without registration:

- Effect unsolicited transactions in securities with US persons;
- Subject to compliance with certain conditions, solicit US persons who are “major US institutional investors”⁷ by furnishing them with research reports;
- Solicit “US institutional investors”⁸ subject to compliance with certain conditions; or
- Solicit and execute transactions directly with *inter alia* SEC registered broker-dealers (whether acting as principal or agent), international entities, non-US persons temporarily present in the United States with which the non-US firm has a pre-existing relationship, non-US agencies or branches of US persons permanently outside the United States (if the trades occur outside the United States).

Advisers and Broker-Dealer Registration

A non-US money manager that manages the portfolio of non-US funds or hedge funds in which US persons have invested would not have any US person clients⁹ and would avoid Advisers Act registration. In engaging in this activity, it would also avoid broker-dealer registration under the Exchange Act. If a non-US money manager offered only advisory and discretionary investment management services to US persons, it would be beyond the reach of broker-dealer registration. It would, however, have to keep in mind the registration requirements of the Advisers Act (and, if it did not register with the SEC as an investment adviser, applicable provisions of state law). A non-US money manager that not only offered advice and discretionary investment management but, using the means of interstate commerce, solicited and executed transactions in securities for US advisory clients (brokerage) and/or offered self-directed accounts (clients place orders on an unsolicited basis) and received transaction-based compensation for it would be engaged in

an activity within the meaning of the term “broker” and, absent an exemption or exception, must register as a broker-dealer with the SEC.

To place this in context, a non-US money manager wishing to access the US markets is encountering a regulatory regime that is different in many ways from that in its home jurisdiction. In many countries, a firm that proposes to engage in asset management and brokerage would obtain a single license from its regulator. Providing its clients with brokerage or self-directed accounts is generally deemed to be incidental to its main activities and does not require a separate registration. In the US regime, broker-dealers and investment advisers are regulated under different statutes that have differing approaches. One entity wishing to engage in both activities requires two separate registrations. The lines between these have blurred due to broker-dealers offering advisory services and wrap programs, and the SEC has had to come to grips with how to regulate such a firm. It has done this through rulemaking (discussed below). It has not, apart from certain no-action letters, addressed the opposite issue, namely, when would an investment adviser be a broker-dealer. While this may not have been an important issue when Rule 15a-6 was adopted in 1989 and in the pre-Internet era, in the context of today’s internationalized markets, it is crucial. Non-US money managers are being asked by US investors to provide them with more than advisory and discretionary investment management services. The provision of these additional services, as well as soliciting US persons to invest in non-US funds and hedge funds, when analyzed under the definition of “broker” and the broad application of “solicitation”, would subject the non-US money manager to broker-dealer registration. Thus, a non-US money manager seeking to provide advice, discretionary investment management services and brokerage or self-directed accounts to US individuals, and soliciting US persons to invest in non-US funds and hedge funds, must, if it has more than 14 advisory clients, register as an investment adviser and must register as a broker-dealer.¹⁰

Non-US money managers have sought to avoid registration as an investment adviser, but some have done so. They are even more reluctant to register as a broker-dealer. For many non-US

money managers, brokerage is ancillary to their primary activities and to engage in this should not require additional registration or regulatory issues. The choices facing a non-US money manager are simple: register as an investment adviser and use an exemption from broker-dealer registration to engage in limited brokerage with institutions, but not individuals; have US persons invest in non-US funds or hedge funds to avoid Advisers Act registration; or not have more than 14 US person clients and not register under the Advisers Act. If a non-US money manager wishes to have individuals as clients and permit them to engage in brokerage activity, solicited or self-directed, it must also register as a broker-dealer, use an SEC-registered broker-dealer or avoid this activity.

These issues are exacerbated further by differences in key definitional terms in the US federal securities laws used in private placements, exemptions from the definition of an investment company and exemptions from broker-dealer registration. For example, the definitional requirements for individuals for private placements in Regulation D under the Securities Act, “accredited investors” and the Investment Company Act of 1940 (1940 Act), “qualified purchasers,”¹¹ are not the same. (The SEC has not yet adopted the proposed definitions of “accredited natural person” and “Rule 507 qualified purchaser.”) Also, the definitions of QIB (under Rule 144A) and “major US institutional investor” (in Exchange Act Rule 15a-6, which is discussed below) are not equal. These definitional differences present issues for distributors of the securities of non-US funds and hedge funds because, for example, it means that institutional investors may be solicited in reliance on a provision of Rule 15a-6 while individuals may not be. The traditional rationale for this distinction is that individual investors require protection while institutional investors are capable of fending for themselves. This does not take into account the fact that the landscape has changed since the adoption of Rule 15a-6 in 1989.

Rule 15a-6 is a non-exclusive safe harbor from broker-dealer registration. As such, it should be possible to establish a series of controls under this safe harbor to permit non-US firms and non-US money managers to engage in limited purpose solicitations

of US individuals, in particular, qualified purchasers. These controls might include the chaperoning requirements that are in place for US institutional investors. The definitional issues might be eased by streamlining key terms across the US federal securities laws, for example, by having a single benchmark to define individuals set at the qualified purchaser level across the Securities Act and the 1940 Act and by equalizing terms for institutions at levels such as US institutional investor and QIB to encompass major US institutional investors. Another possibility might be to adopt an approach similar to that in MiFID which has three types of investors: (1) retail clients, (2) professional clients, and (3) eligible counterparty.

Non-US Money Managers and Brokerage

There are few no-action letters and official SEC pronouncements that address the application of the Exchange Act broker-dealer registration provisions to investment advisers. Generally, an adviser that transmits orders to buy or sell securities to brokers, dealers or banks for execution, does not provide custody and does not receive transaction-based compensation would not fall within the definition of “broker” and not be required to register as a broker-dealer.¹² Going beyond this and soliciting and providing brokerage, offering self-directed accounts and/or regularly sending research, and receiving transaction-based compensation, would require broker-dealer registration.¹³

Rule 15a-6 would permit a non-US money manager to solicit a major US institutional investor to engage in brokerage and self-directed beyond advisory and discretionary investment management activities. A non-US money manager needs an SEC registered broker-dealer and a Rule 15a-6 chaperoning agreement to be able to approach a US institutional investor under Rule 15a-6. However, and by its terms, Rule 15a-6 is not available to a non-US money manager to approach any person that was not a major US institutional investor or a US institutional investor, namely, an individual. In that case, solicitation of any activity beyond advisory or discretionary investment management could be made only by an SEC-registered broker-dealer, or not at all.

Soliciting US Persons to Buy Securities of Non-US Funds or Hedge Funds

To help determine whether a person is a broker, the SEC's Division of Trading & Markets (formerly Market Regulation) uses a facts and circumstances analysis in which it asks:

- Is the person engaged in the business of buying or selling securities;
- Does the activity constitute effecting a transaction in securities for the account of others; and
- Does the person receive transaction-based compensation?

Of these, the factor that is most determinative, as cited in several no-action letters, is the receipt of transaction-based compensation.¹⁴

A non-US money manager solicits US persons to purchase the securities of non-US funds or hedge funds (single entity funds and feeder funds in master feeder structures). Seeking funds from US persons to buy securities in non-US funds or hedge funds would be a solicitation in connection with the purchase or sale of a security and subject the solicitor involved to broker-dealer registration. Because non-US money managers generally do not solicit investors to purchase additional shares, receive transaction-based compensation or holding themselves out publicly as being engaged in the business of buying or selling securities—their activities are to manage the portfolio of the non-US fund or hedge fund (single entity or master fund)—it would be difficult to apply all three of the elements of the facts and circumstances test and conclude that they should register as a broker-dealer. A different result would, rightly, apply to a distributor (or, as used for Advisers Act purposes, a solicitor) that engages in this activity and receives transaction-based compensation.

A fall-back position for a non-US money manager that sought US persons to invest in the non-US funds or hedge funds that it managed and wished to avoid broker-dealer registration would be to solicit major US institutional investors under Rule 15a-6 or use SEC-registered broker-dealers to solicit US institutional investors. The non-US fund or hedge

fund would be exempt from registration under the 1940 Act under the exemption afforded by 1940 Act Section 3(c)(7)¹⁵ (today, non-US funds and hedge funds rarely use the “100 person” exemption under Section 3(c)(1) of the 1940 Act). To go this route, the non-US money manager would first have to categorize its US prospect, not just as a qualified purchaser but as a US institutional investor or a major US institutional investor. It would then solicit the major US institutional investor prospects and use SEC-registered broker-dealers to solicit the US institutional investor prospects. It could not, however, solicit individuals that satisfied the qualified purchaser test. These prospects would have to be solicited directly by an SEC registered broker-dealer. This helps demonstrate that a non-US money manager would not be able to solicit US prospects in single manner: it would have to use three approaches to accomplish this. This is costly, time consuming, creates regulatory complications and results in the non-US money manager turning away US prospects.

Mutual Recognition

Mutual recognition posits that a firm that is engaged in financial services in one jurisdiction (home country) may, subject to compliance with certain requirements, engage in that activity in a second jurisdiction (host country) without having to register in the host country. The host country regulatory authority would accept the licensing and prudential regulation of the firm in question by the home country regulator.¹⁶ This is the concept underlying the passport enshrined in MiFID and its predecessor, the Investment Services Directive. The concept of registration under MiFID contemplates a single license.

Mutual recognition was raised as a topic in 1989 when Rule 15a-6 was adopted. Since then, mutual recognition in the United States for non-US firms (as broker-dealers) and non-US money managers (as investment advisers) has not been pursued. Certain developments have, however, revived this development. These include the NYSE-Euronext merger, the March 2007 speech, “Trading Foreign Shares,” by Eric R. Sirri, Director of the SEC's Division of Trading & Markets¹⁷ and the June 2007 roundtable on mutual recognition. As a result, the SEC is considering mutual recognition in the sense of

permitting, subject to compliance with certain conditions, non-US exchanges or even broker-dealers to enter the US markets.

As noted, outside the United States, financial services industry participants generally register with a single regulator and obtain a single license to engage in one or more activities. In the United States, a firm that offers advisory and discretionary investment management services would register as an investment adviser and a firm that engaged in brokerage transactions for its account or for the account of others would register as a broker-dealer. The lines between these industry participants in the United States have become blurred. The SEC has not formally tackled the issue of when an investment adviser would be a broker-dealer.¹⁸

A Way Forward

The primary goals of the US federal securities laws are to protect investors, ensure fair, orderly markets and mandate for full and accurate disclosure. The Advisers Act is intended to protect investors by requiring registered investment advisers to act in the best interests of their clients and avoid conflicts of interest or, when conflicts cannot be avoided, to disclose those conflicts and employ controls to minimize risk and avoid harm.

The issue for a non-US money manager is how to access the US markets in a way that helps it avoid a bifurcated approach to registration and regulation, brought on by the differing regulatory approaches to investment advisers and broker-dealers in the United States and in its home country. The issue to US investors, in particular, individuals, is how to access the non-US markets and non-US products in a cost effective manner. The concern of regulators, as regards individual investors, is how to protect them.

Mutual recognition would play a role in reducing the barriers to entry so that a non-US money manager that was subject to a level of prudential and conduct of business regulation equivalent to that of the United States could to enter the US markets. The blueprint for such a process would be the passporting regime in MiFID, with a number of enhancements. This, however, avoids the key issue of

whether a non-US money manager that is primarily engaged in providing advice and discretionary investment management and that might offer brokerage or self-directed activity as an ancillary service would be deemed to be a broker and must register with the SEC as a broker-dealer.

There are several options available to address the issue of how non-US money managers may engage in limited purpose brokerage or self-directed activity for US individual investors without having to register as a broker-dealer.

One option is to revise Rule 15a-6 to have the safe harbors address two categories of investors: QIBs; and all others, institutional and individual. (The professional to professional safe harbor would remain unchanged.) The term “major US institutional investor” would be changed to or become the equivalent of “QIB” (to further a degree of parity between the Securities Act and the Exchange Act. The term “US institutional investors” would become “US investors” and include all other investors, institutional and individual. These “US investors” would be treated as US institutional investors are today and contacts would be subject to the chaperoning requirements that apply to US institutional investors.

Another option would be to provide a safe harbor from broker-dealer registration, apart from Rule 15a-6, for limited purpose brokerage or self-directed activity for home country-regulated non-US money managers, subject to safeguards. This option would be based on mutual recognition and reporting and disclosure requirements.

A third option would be, in the context of mutual recognition, to recognize the regulation of non-US money managers that permitted their clients to engage brokerage and self-directed brokerage, on the basis that this activity was ancillary to the non-US money manager’s primary activities.

A fourth option would be to adopt a rule under the Advisers Act providing that self-directed brokerage fell within the ambit of investment adviser registration and regulation. A variation of this option would be to carve out of the definition of broker

home country authorized and regulated non-US money managers and non-US firms that provided self-directed brokerage not as their primary activity and that did not receive transaction-based compensation.¹⁹

At the same time, the SEC would have an opportunity to address the issue of unequal definitions across the US federal securities laws and adopt amendments that smooth the avenues used to solicit US investors to buy and sell the securities of non-US issuers. This could include a concept release examining the broad definition of solicitation in the context of recent market developments, mutual recognition, the concept of a single act touching off the broker-dealer registration provisions, and the activities of non-US money managers.

Conclusion

The SEC has, for several years and in many ways, been at the forefront of financial services regulation. It has revised its regulatory requirements to take account of developments such as globalization and the Internet, while continuing to administer and enforce the federal securities laws. These developments include Regulation S, “access equals delivery” for prospectus and proxy delivery requirements, no-action relief under Rule 15a-6, the roadmap to end IFRS-US GAAP reconciliations for foreign private issuers and free writing prospectuses and concessions to well known seasoned issuers under the Securities Offering Reforms. The SEC is also at the forefront of investor protection, as evidenced by its effective enforcement program, foreign as well as domestic.

As markets change, so, too, does the SEC’s approach to internationalization. There is an opportunity to permit non-US money managers to gain access to US investors, including individuals, in a manner that keeps this activity within the US regulatory system, not outside it. It is better to design a regulatory solution to the present and evolving situation rather than letting investors pursue avenues to access the non-US markets and non-US products outside the regulatory system. The options above, and also mutual recognition, can be the vehicle for regulatory initiatives to remove barriers that prevent non-US money managers from accessing the US

markets and further protect the interests of US individual investors as they have new, profitable markets opened to them.

NOTES

1. *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006).
2. Under Advisers Act Section 203(b)(3), any person who, for compensation, is engaged in the business of providing investment advice to 15 or more customers in a 12-month period must register with the SEC. Having 14 or fewer clients is the “*de minimis* exemption.”
3. “Interstate commerce” is defined in Section 2(a)(7) of the Securities Act to include transportation or communication “between any foreign country and any State, Territory, or the District of Columbia”“ Section 3(a)(17) of the Exchange Act defines “interstate commerce” as “trade [or] commerce ... between any foreign country and any state.”
4. This excludes a person that buys or sells securities for its own account, “individually or in a fiduciary capacity, but not as a part of a regular business,” e.g., hedge funds that trade for their own account.
5. The term “solicitation” is not defined in a rule, but was articulated in the release adopting Rule 15a-6, a safe harbor from broker-dealer registration and, since then, has been restated in various no-action letters and other SEC pronouncements. *See* Exchange Act Release 27017, 54 FR 30013, July 18, 1989.
6. Newly adopted Regulation R permits US banks to engage in certain securities activities without having to register with the SEC as a broker-dealer under the Exchange Act. It does not apply to non-US banks. Due to the broad definition of the term “broker” and the SEC’s position with respect to solicitations, it is conceivable that a non-US bank that uses the means of interstate commerce to solicit US persons to open a securities account or to engage in transactional business and is remunerated with transaction-based compensation would be a “broker” and, absent an exception or exemption, would have to register as a broker-dealer.
7. A “major US institutional investor” is any entity that owns, controls, or has under management more than US\$100m in aggregate financial assets.
8. A “US institutional investor” is: an SEC registered investment company; a bank, savings and loan association, insurance company, business development company, small business investment company or employee benefit plan defined in Securities Act Regulation D Rule 501(a)(1); a private business development company defined in Rule 501(a)(2) of Regulation D; an organization described in Section 501(c)(3) of the U.S. Internal Revenue Code of 1986, as amended; or a trust defined in Rule 501(a)(7) of Regulation D.
9. A US investor that held 10 percent or more of the securities of such a fund would have to be counted towards the 15 person registration threshold in Advisers Act Section 203(b)(3).
10. A non-US money manager may offer brokerage to certain institutional investors without having to register as a broker-dealer in reliance on Exchange Act Rule 15a-6.

11. A “qualified purchaser” is defined in Section 2(a)(51) of the 1940 Act and, in relevant part, includes natural persons who own at least \$5 million in “investments” (securities, real estate, commodities, financial contracts, cash and cash equivalents when they are held for an investment purpose) and institutional investors that own and invest on a discretionary basis at least US\$25 million in investments.

12. *See, e.g.*, In Touch Global LLC (November 14, 1995).

13. *See, e.g.*, PRA Securities Advisers LP (March 3, 1993).

14. *See, e.g.*, Wolff Juall Investments, LLC (May 17, 2005), citing Birchtree Financial Services (September 22, 1998), 1st Global (May 7, 2001) and Herbruck, Alder & Co (May 3, 2002).

15. Section 3(c)(7) permits a non-US fund or hedge fund to sell its shares in the United States on a private placement basis as long as every US investor is a qualified purchaser. There is no limit in Section 3(c)(7) on the number of qualified purchasers. However, a non-US fund or hedge fund that has more than 500 investors (300 US residents) and US\$10 million in assets within 120 days after the end of its most recent fiscal year must register with the

SEC under Exchange Act Section 12(g). The newly adopted foreign private issuer deregistration regime is not available for funds. A Section 3(c)(7) fund should never have more than 299 US qualified purchasers.

16. The concept of authorization under MiFID contemplates a single license.

17. “Trading Foreign Shares,” March 1, 2007 by Erik R. Sirri, Director, Division of Market Regulation (now Trading & Markets), Securities and Exchange Commission (www.sec.gov/news/speech/2007/spch030107ers.htm).

18. It has, however, dealt with the opposite issue, when it adopted Advisers Act Rule 202(a)(11).

19. In Exchange Act Release 53406, March 3, 2006, the SEC announced that it would conduct a review to compare the levels of protection to retail customers under the Advisers Act and the Exchange Act regarding the activities of investment advisers and broker-dealers. Hopefully, the results of this would bear out that the regulatory principles underlying the protections afforded to clients of broker-dealers and investment advisers have common elements and that there is a basis on which to permit a degree of common regulation.

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