Chapter 5

The Reach of the Investment Advisers Act of 1940

I. Introduction and Summary of Recommendations

One area of great importance for the internationalization of investment management services is the reach of the Investment Advisers Act.[1] Under existing interpretations, the Advisers Act is applied on an "entity" basis. That is, when an investment adviser, whether foreign or domestic, registers under the Advisers Act, all of the adviser's activities everywhere are subject to the Act.[2] Many of the Advisers Act's provisions differ from or exceed those that apply to foreign advisers under the laws of their home country and also may be contrary to accepted business practices there. Consequently, a foreign adviser that registers under the Advisers Act because it does business with clients in the United States, as well as in its home country, may find itself unable to engage in conduct that is legal and acceptable business conduct in its home country because the Act prohibits it. To avoid this result, some foreign advisers establish "independent" subsidiaries, registered under the Advisers Act, to advise their clients here. Those subsidiaries, however, are subject to strict conditions that may reduce the amount and quality of investment advice available to investors in the United States.[3]

The Division has reexamined the current interpretations on the reach of the Advisers Act and concluded that they should be changed.[4] We recommend

[1] Investment Advisers Act of **1940, 15** U.S.C. § 80b.

[2] *See infra* note **7** and accompanying text. We use "domestic adviser" to refer to **an** adviser whose offices and personnel are located in the United States and "foreign adviser" to refer to an adviser whose offices and personnel are located outside the United States.

[3] *See infra* notes **9-15** and accompanying text.

[4] The Commission received eight comments on this topic in response to SEC Request for Comments on Reform of the Regulation of Investment Companies, Investment Company Act Release No. **17534** (June **15,** 1990), **55** FR **25322,** all critical of the current positions. The commenters were certain members of **a** subcommittee of the American Bar Association; Citicorp; Cleary, Gottlieb, Steen & Hamilton; Davis Polk & Wardwell; Debevoise & Plimpton, on behalf of Westpac Banking Corporation; Dechert Price & Rhoads; Ropes & **Gray;** and Kathleen A. Veach. In addition, Debevoise & Plimpton, with the assistance of several other law firms, provided the Division with a memorandum entitled *International Survey of Investment Adviser Regulation* (Aug.,

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applying the Advisers Act on a more narrow basis tied to "territorial" concepts focusing on conduct and the effect of conduct. Under such an approach, the Advisers Act would apply to activities where a sizable amount of advisory services takes place *in the United States* or where the advisory services have effects *in the United States.* Thus, where a registered foreign adviser or a registered domestic adviser deals with clients resident in the United States, it can be assumed that a sizable amount of advisory services will take place in the United States and that there will be effects in the United States and the Advisers Act will apply. Where, however, a registered foreign adviser deals with a client residing outside the United States, the Advisers Act generally will not apply. A more difficult question arises where a registered domestic adviser deals with a client residing outside the United States. In such a case, a sizable amount of advisory services is likely to take place in the United States and the Advisers Act ordinarily will apply. Another difficult question arises where either a foreign or a domestic adviser is multinational, that is, has offices outside its foreign or domestic base. Here again, application of the Advisers Act will depend on whether a sizable amount of advisory services takes place in the United States. Thus, for instance, if a domestic adviser has a branch office in a foreign country, and has a corporate policy requiring that all portfolio decisions regarding clients residing in that country come from that foreign office, then the Advisers Act generally would not apply. If, on the other hand, the client wishes to invest in United States markets and the firm's personnel located in the United States are involved in formulating or providing advice, the Advisers Act generally would apply![5] Because of the fact-specific nature of these issues, close cases would be addressed on a case-by-case approach through interpretive and no-action letters.

Although the approach we recommend would lessen the need to create separate subsidiaries, some investment advisers still may wish to form separate entities. We recommend revision of the criteria for the formation and registration of separate subsidiaries.

This chapter begins with a discussion of the existing positions on the reach of the Advisers Act and some of the interpretive and practical difficulties they present. It then discusses a new approach to application of the Advisers Act, based upon conduct and effect of conduct, and the policy considerations that

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1990) [hereinafter *International Survey*] with analyses of the investment advisory laws of Australia, Brazil, France, Germany, Japan, Switzerland, and the United Kingdom.

[5]**In Chapter 6, however, we recommend legislation that would authorize the Commission to exempt** from **the Advisers Act's prohibition on performance-based advisory fees with persons** not **residing in the United States to the extent that such fees are lawful in the client's country of residence.**

support that approach. This chapter also describes the alternatives that the Division considered but does not recommend.

II. The Reach of the Investment Advisers Act -- The Current Approach

Section 203 of the Advisers Act requires the registration of any investment adviser, whether domestic or foreign, that uses the United States mails or any other means or instrumentality of interstate commerce in connection with its business as an investment adviser, unless the adviser is exempted from registration? The Division has stated that, once registered, domestic and foreign advisers are subject to all the substantive provisions of the Advisers Act with respect to both their United States and non-United States clients?

[6]Section 202(a)(10) defines "interstate commerce" to include "trade, commerce, transportation, or communication . . . between any foreign country and any State. . . ." 15 U.S.C. § 80b-(a)(10). Section 202(a)(11) defines an "investment adviser" to mean, with certain exceptions, "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 . . . ." A foreign adviser to clients residing outside the United States may use limited United States jurisdictional means without triggering the registration requirements of the Advisers Act; that is, it may acquire information about securities of United States issuers and effect transactions in securities through United States broker-dealers. Gim-Seong Seow (pub. avail. Nov. **30,** 1987). In contrast, a domestic adviser dealing exclusively with foreign clients must register if it uses any jurisdictional means in connection with its advisory business. *Id.*

The Advisers Act exempts from registration any adviser that has fewer than 15 clients and that neither holds itself out as an adviser nor acts as an adviser to any registered investment company. Investment Advisers Act § 203(b)(3), 15 U.S.C. § 80b-3(b)(3). Domestic advisers and foreign advisers have been treated differently in determining whether foreign clients should be counted. Domestic advisers are required to count foreign clients; foreign advisers are not. See, *e.g.*, Murray Johnstone Ltd. (pub avail. Apr. 17,1987); Alexander, Holburn, Beaudin & Lang (pub. avail. Aug. 13,1984); S&R Management Co. (pub. avail. May 8,1975). *But* see Walter L. Stephens (pub. avail. Nov. 18, 1985) (indicating no distinction).

Section 203(b) also exempts from registration certain "intrastate" advisers and advisers to insurance companies. The Advisers Act's antifraud provision, section *206* (15 U.S.C. § 80b-6), by its terms applies to any adviser, whether or not required to register, that is using the jurisdictional means.

[7]Reavis & McGrath (pub. avail. Oct. 29, 1986). On one occasion, a registered foreign adviser received a no-action response where it proposed not to comply with the performance fee limits, among other things, with respect to its home country clients. **Nikko** Sec. Inv. Trust & Management Co., Ltd. (pub. avail. May 17,1985). Since the response concerned only performance fees and one other aspect of adviser regulation, the adviser presumably was required to comply (continued...)

This poses a number of problems for foreign advisers. For example, a registered foreign adviser that provides advice both to United States clients and to clients in its own country may find that it is unable to engage in legal and acceptable business conduct in its home country because the Advisers Act prohibits the conduct. The most striking example of this is the use of performance-based advisory fees. While advisory fees based on investment performance are legal and in fact accepted business practice in many countries, the Advisers Act restricts their use.[8] Thus, a foreign adviser that registers in the United States to advise United States clients finds that it is prohibited from entering into fee arrangements with clients in its home country that are otherwise lawful in that country.

To avoid this broad reach of the Advisers Act, a foreign adviser may form a separate and independent subsidiary to provide advice to United States clients. Under current positions, however, such a subsidiary will only be "regarded as having a separate, independent existence and to be functioning independently of its parent," thereby permitting the foreign parent to remain unregistered, if the subsidiary satisfies the following five conditions (known as the *"Ellis* conditions," after the no-action letter in which they were set forth)? The subsidiary must: (1) be adequately capitalized; (2) have a "buffer" between the subsidiary's personnel

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with the other provisions of the Advisers Act, including the recordkeeping and antifraud provisions, with respect to all of its clients. This was an "enforcement only" response, however, not an interpretive one, and the Division subsequently indicated that all provisions of the Advisers Act apply to a registered adviser's dealings with foreign clients. Reavis & McGrath, supra.

The Commission has taken a similar position with regard to broker-dealers registered under the Securities Exchange Act of 1934 (15 U.S.C. §§ 78a-78*ll*). Once a broker-dealer is registered, it is subject to the full panoply of United States broker-dealer regulations. See Registration Requirements for Requirements for Broker-Dealers, Exchange Act Release No. 27017, at III.A, III.B.l (July 11, 1989), 54 FR 30013 ("if a foreign brokerdealer . . . becomes subject to U. S. registration requirements, . . . the regulatory system governing U.S. broker-dealers would apply to the entire brokerdealer entity").

'Advisers Act § 205(a)(1), 15 U.S.C. § 80b-5(a)(1). See Chapter 6 for the Division's recommendations concerning performance fees.

[9]Richard Ellis (pub. avail. Sept. 17, 1981). The status of separate affiliates under common control has not been definitively resolved. Compare H.P. Hambrick Co., Inc. and Pajolo A.G. (pub. avail. Oct. 14,1988) (indicating that questions could arise where a United States resident adviser provides advisory services to foreign clients through an unregistered wholly owned foreign corporation, particularly where the individual also provides advice to United States clients through another wholly owned corporation registered as an adviser with the Commission) *with* TAC America, Ltd. (pub. avail. July 25,1984) and Double D Management Ltd. (pub. avail. Jan. 31, 1983) (performance fee provisions of the Advisers Act not applicable to unregistered foreign affiliates of registered advisers, even where the affiliates have common personnel).

and the parent, such as a board of directors a majority of whose members are independent of the parent; **(3)** have employees, officers, and directors, who, if engaged in providing advice in the day-to-day business of the subsidiary entity, are not otherwise engaged in an investment advisory business of the parent; (4) itself make the decisions as to what investment advice is to be communicated to, or is to be used on behalf of, its clients, and has and uses sources of information not limited to its parent; and (5) keep its investment advice confidential until communicated to its clients." All five criteria were believed to be necessary to establish that the parent company was not doing indirectly under the Advisers Act what it could not do directly, in violation of section 208(d).[11]

While the *Ellis* conditions were designed to ameliorate the problems created by the Division's interpretations of the reach of the Advisers Act, they

[10]The *Ellis* conditions were derived from a 1972 Commission release proposing a rule that would have set forth virtually identical conditions under which an affiliate formed to provide advisory services would be deemed an autonomous entity. The Commission noted, however, that "[w]hether a registered investment adviser is merely a conduit for advisory services provided by its controlling person or **an** affiliate of such controlling person, depends in each case upon the substance of the arrangement." Notice of Proposals under the Investment Advisers Act to **(1)** Adopt New Rule 202-1 under the Investment Advisers Act of 1940, as amended ("Advisers Act"), with respect to Exemption from the Definition **of** "Investment Adviser," and (2) Amend Rule 204-2(a) under the Advisers Act by Amending Paragraph (12) and Adopting New Paragraphs (13) and (14) thereunder with respect to Record-Keeping Requirements for Certain Investment Advisers under the Advisers Act, Investment Advisers Act Release No. **353** at n.2 and accompanying text (Dec. 18, 1972), 38 FR 1649. The proposed rule (redesignated Advisers Act proposed rule 202-2 in Investment Advisers Act Release No. 369 (Feb. 21, 1973), *36* FR 5912) would have provided an exemption from registration for the company controlling the registered adviser and affiliates **of** the controlling company if the enumerated conditions were satisfied. ***Id.*** at 1650. The Commission withdrew the proposed rule in 1976 without explanation. Notice of Withdrawal **of** Proposed Rule 202-2 under the Investment Advisers Act of 1940, Investment Advisers Act Release No. 497 (Feb. 19, 1976), 41 FR 8498.

[11]15 U.S.C. § 80b-8(d). Section 208(d), which was added in 1960 (Pub. **L.** No. 86-750, § 11(b), 74 Stat. 885, 887), provides: "[i]t shall be unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of this title or any rule or regulation thereunder." The legislative history of the section indicates that it is based on section 20(b) of the Exchange Act **(15** U.S.C. § 78t(b)). See S. REP. NO. 1760, 86th Cong., 2d Sess. 8 (1960). The Exchange Act, however, has not been interpreted to require compliance with conditions similar to those in *Ellis* in establishing a separate broker-dealer affiliate. In determining whether **a** foreign broker-dealer must register, the Commission has indicated that sharing personnel with a registered entity is permissible, as long as the registered entity maintains appropriate supervision and control of shared personnel, and certain other conditions are met. Exch. Act Rel. 27017, *supra* note 7, 54 FR at 30017 ("the Commission believes that it is consistent with these principles for a registered representative stationed outside the United States with a foreign broker-dealer to contact personnel in the United States from within or without this country on behalf of the registered broker-dealer"). The foreign broker-dealer may not control the registered broker-dealer's day-to-day market making activities, however. See ***id.*** at n.205 and accompanying text.

pose great difficulties in practice?' The separate personnel requirement, in particular, has harsh effects. A foreign parent adviser may be unable to employ its most talented portfolio managers on United States accounts, since such portfolio managers may be required to bring their specialized expertise to bear on a larger proportion of business represented by non-United States accounts served by the parent. It is probably unrealistic to expect that a foreign adviser would make a valuable portfolio manager unavailable to its non-United States clients by transferring the manager to a subsidiary registered under the Advisers Act. Finding another portfolio manager with equivalent expertise to work in the registered subsidiary is inefficient and may be impossible. Thus, as a practical matter, because of the Ellis conditions, United States clients may have limited access to advisory personnel with expertise in particular specialized markets.[13]

The *Ellis* conditions concerning the flow of information also may have deleterious consequences. While portfolio managers working in a registered subsidiary have the benefit of research materials generated by the parent, and may participate in some circumstances in discussions with personnel of the parent concerning current trends and allocation of portfolios between industries and national markets, the conditions may prohibit day-to-day exchanges of ideas and discussions between portfolio managers of the parent and subsidiary. **As** a result, a foreign adviser's ability to provide the best available service to United States clients likely is impeded.

In addition, while Ellis requires the registered subsidiary of a foreign adviser to be adequately capitalized, *Ellis* does not provide any guidance as to what constitutes adequate capitalization.[14] Investment advisers do not have to meet capital requirements under the Advisers Act.[15] Finally, assuming that an

[12]The *Ellis* conditions have been characterized as "unworkable." Greene, Dupler, and Cohen, *Jurisdictional Reach of the Investment Advisers Act* of *1940,* INSIGHTS, OCT. 1990, at 21/27 (1990).

[13]*See* Letter from Davis Polk & Wardwell to Jonathan G. Katz, Secretary, SEC 27-29 (Oct. 10, 1990), File No. S7-11-90.

[14]Inv. Adv. Act Rel. **353,** *supra* note 10, when proposing the rule originally proposed **as** Advisers Act rule 202-1, appeared to suggest that all that was required was sufficient capital to avoid the affiliate being a shell. Inv. Adv. Act Rel. **353,** ***supra*** note 10. If this is the capital level to which ***Ellis*** refers, it would not appear burdensome, being essentially consistent with state corporate law concepts of separateness.

[15]Many states impose a net capital or minimum net worth requirement. *E.g.,* N.C. **GEN.** STAT. § 78C-17. Other states apparently have the authority to **do** so, but have not exercised that authority. *E.g.,* S. D. CODIFIED LAWS *ANN.* § 47-31A-202 (119). At least one state, Arkansas, exempts investment advisers registered under the Advisers Act from that state's capital requirements. ARK. STAT. **ANN.** § 23-42-303(b).

adequate level of capital could be determined, this condition nonetheless requires a foreign adviser to divide its capital for seemingly artificial purposes.

111. A Conduct and Effects Application of the Investment Advisers Act

A. The Statute's Jurisdictional Reach

The language of the Advisers Act does not contain explicit territorial restrictions, except that a number of provisions require the use of jurisdictional means to establish a violation:' Other parts of the federal securities laws also lack explicit territorial limits. The Commission, through rulemaking and interpretation, has sought to balance the literal reach of those provisions with the legislative purpose underlying the particular statute, principles of international law as recognized in the United States, and the realities of global markets.[17] This has resulted in an emphasis on territorial limits in applying the regulatory requirements of the federal securities laws, with the precise limits being determined by reference to the language, legislative history, and purposes of the specific provision at issue.

Generally, statutes are applied to regulate activity taking place outside the United States where that activity produces substantial and foreseeable effects in the United States or involves conduct occurring in the United States, even if the conduct has no effect on United States persons or markets. These principles of jurisdiction -- known as the "conduct" and "effects" tests -- are well-established in other areas of the law and have been applied frequently in determining the application of the federal securities laws to foreign persons and conduct.[18]

The conduct and effects tests have been most often used as bases for asserting jurisdiction under the federal securities laws' antifraud provisions.

[16]Despite **this absence of restrictions, the Advisers Act's substantive regulations have not been applied with respect to foreign advisers with** *de minimis* **connection to or activity in the United States.** *See supra* **note 6.**

[17]One **example is the Commission's approach under the Securities Act of 1933 (15 U.S.C. §§ 77a-77aa), which is codified in Regulation S (17 C.F.R. §§ 230.901-.904).** *See* **Offshore Offers and Sales, Securities Act Release No. 6863 (Apr. 24, 1990), 55 FR 18306. In regulating broker-dealers, the Commission uses a territorial approach in applying the registration requirements, but regulates registered broker-dealers under an entity approach.** *See* **Exch. Act. Rel. 27017,** *supra* **note 7, at III.B.1.**

[18]*See infra* **notes 19-22.** *See also* **RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 402 (1987) [hereinafter RESTATEMENT (THIRD)]; RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES §§ 17/18 (1965).**

Under the conduct test, acts that are committed in the United States in furtherance of a fraudulent scheme and are more than merely preparatory are sufficient to justify application of the federal securities laws to the unlawful conduct.[19] Courts have concluded that Congress did not intend for this country to be used as "a base for manufacturing fraudulent security devices for export,"[20] or to become "a 'Barbary Coast' . . . harboring international securities 'pirates'" whose victims are foreign?' Under the "effects" test, the federal securities laws may be applied to conduct overseas that injures or defrauds United States investors or adversely affects a United States listed security.[22]

The antifraud provisions of the securities laws have typically been given broader effect than purely regulatory provisions.[23] Nevertheless, if the effect in the United States is sufficiently significant, or the conduct sufficiently important, the assertion of regulatory jurisdiction is appropriate.[24]

B. **Policy** Considerations **Favoring a** New **Approach**

The Division believes that a conduct and effects approach to the Advisers Act is consistent with important policy considerations and that the Act should be

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[19] *See, e.g.,* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326 **(2d** Cir. 1972) and Continental Grain (Australia) Pty. Ltd v. Pacific Oilseeds, Inc., 592 F.2d 409, 421 (8th Cir. 1979) (misrepresentations made in the United States for securities transactions consummated abroad); *cf.* Psimenos v. E.F. Hutton & Co., 722 F.2d 1041, 1045 (2d Cir. 1983) (fraudulent practices with respect to foreign client prohibited by United States law where practices concerned trades executed for client on United States commodity exchange).

[20] IIT v. Vencap, Ltd., 519 F.2d 1001,1017 (2d Cir. 1975).

[21] SEC v. Kasser, 548 F.2d 109, 116 (3d Cir. 1977), *cert. denied,* 431 U.S. **938** (1977).

''*See e.g.,* Consolidated Gold Fields, PLC **v.** Minorco, S.A., 871 F.2d 252 (2d Cir. 1989); Bersch v. Drexel Firestone, 519 F.2d 974,993 (2d Cir. 1975), *cert. denied,* 423 U.S. 1018 (1975); Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), *rev'd on other grounds,* 405 F.2d 215 (2d Cir. 1968) (en banc), *cert. denied,* 395 U.S. 906 (1969).

[23] *See* Plessey Co., PLC v. General Electric Co., 628 F. **Supp.** 477 (D. Del. 1986); *see also* Consolidated Gold Fields, 871 F.2d at 262-63 (distinguishing between the enforcement of United States regulatory and antifraud jurisdiction).

[24] Indeed, the RESTATEMENT (THIRD) recognizes the regulation of investment advice rendered in the United States as a reasonable assertion of regulatory jurisdiction. **RESTATEMENT** (THIRD), ***supra*** note 18, § 416.

applied more narrowly, in keeping with that approach.[25] Under general principles of comity, nations recognize legislative and judicial acts of other nations, having due regard for the rights of their own citizens. Comity suggests that the Advisers Act should not apply to a foreign registered adviser's relationship with its non-United States clients outside the United States, just as the Commission would not expect the laws and regulations of a foreign country to apply to a United States adviser's relationship with its United States clients.[26]

A strong argument also can be made that foreign clients of foreign advisers do not expect, and may not desire, a foreign adviser to be subject to the Advisers Act. Assuming a foreign adviser does not hold itself out as being registered under the Advisers Act, there would be no apparent reason for a foreign investor to expect to be protected by United States law.

In addition, a conduct and effects approach is consistent with Commission efforts to remove unnecessary barriers to international securities markets. Today, foreign investment advisers may be reluctant to register under the Advisers Act so that they may advise United States clients because to do so subjects all their non-United States advisory operations to United States law. Their avoidance has the unfortunate effect of limiting United States investors' access to foreign advisory expertise.

Just as important, under a conduct and effects approach, the Commission still would be able to reach conduct that affects United States markets and United States clients. For example, where a foreign adviser's dealings with non-United States clients operate to defraud its United States clients, such as where the adviser was "front-running" trades of United States clients, the Advisers Act would apply since the acts would affect a United States client. Given these protections, little purpose is served by requiring foreign advisers to comply with all of the United States requirements regarding their non-United States clients.

[25]Several commenters recommended a similar approach on policy grounds, as have other observers. See, *e.g.*, Letter from Dechert Price & Rhoads to Jonathan G. Katz, Secretary, SEC 26 (Oct. 10, 1990), File No. S7-11-90 [hereinafter Dechert Price Study Comment]; Greene, Dupler, and Cohen, supra note 12.

[26]We understand the laws of other countries generally reflect these principles. For example, the United Kingdom does not apply certain of its investment advisory laws to the foreign activities of foreign investment advisers registered there. See Rule 28.01 of the Rules of the Investment Management Regulatory Organization Limited (1988) [hereinafter IMRO Rules]. Brazil's regulations do not apply to activities of registered investment managers outside Brazil. *International* Survey, *supra* note 4, at 111-13. Japanese law does not apply to the dealings between registered foreign-based advisers and their clients located outside Japan. Id. at VI-40. France applies its laws extraterritorially, *id.* at xviii-xix, but the activities of affiliates apparently are not subject to review to ensure separateness from the entity seeking to register. Id. at IV-2.

We recognize that the approach we recommend may appear to differ from that taken by the Commission with respect to broker-dealer regulation. A closer look, however, reveals that the underlying rationale is entirely consistent. It is appropriate to use an entity analysis to apply the broker-dealer provisions of the Exchange Act to the foreign activities of a registered broker-dealer, for example, because of the consequences of such activities for the broker-dealer's net capital position. The Advisers Act, however, emphasizes disclosure and fiduciary obligations and does *not* regulate financial safety and soundness.[27] Accordingly, conduct by a registered foreign adviser outside the United States, with non-United States clients, is much less likely to implicate United States regulatory concerns.

C. Access to Books and Records and Personnel

Although the activities of a registered foreign adviser with its foreign clients should not generally be subject to the Advisers Act, the Commission should require United States registered foreign advisers to keep certain records with respect to their offshore activities.[28] Because the offshore activities of a registered foreign adviser may have a significant effect on United States clients, these records will enable the Commission to carry out an effective examination program. In addition, the Commission will need access to foreign personnel of the adviser, even where those personnel do not deal with United States clients. The Commission's interest in the offshore activities of a registered foreign adviser, however, will generally be limited to obtaining access to information concerning trades by the adviser and its affiliates and foreign clients in order to monitor and enforce compliance with the adviser's obligations to its United States clients.

D. Implications of a New Approach

The implications of the approach we recommend, for both foreign and domestic advisers, are discussed below. Of course, in some cases, determination of whether the Advisers Act applies will be fact-specific.

[27]From time to time, various persons, including the Commission, have suggested amending the Advisers Act to impose capital requirements on investment advisers. If the Advisers Act were amended to address financial safety and soundness concerns, we would expect to revisit this topic.

[28]Rule 204-2 under the Advisers Act (17 C.F.R. § 275.204-2) already requires, among other things, that registered advisers maintain records of not only their trades, but also of trades by any controlling persons or affiliates thereof who obtain information about investment advice before it is effectively disseminated.

1. Foreign Advisers and United States Clients

The conduct and effects approach generally would not affect the regulation of the relationships between registered foreign advisers and United States clients. If a foreign adviser has fifteen or more United States clients, it must register under the Advisers Act. Once registered or required to be registered, all of the foreign adviser's advisory activities with United States clients would be subject to the full panoply of the Advisers Act's requirements. This can be justified on either a conduct or effects basis -- sizable activity will take place in the United States or there will be an effect in the United States.

One issue that would arise more frequently under this approach is who is a "United States client" protected by the Advisers Act.[29] For example, while undoubtedly all persons resident in the United States are protected, the status of United States citizens abroad as clients protected by the Advisers Act has not been addressed. If the Commission takes a conduct and effects approach to the reach of the Advisers Act, we would expect to address these questions on a case-by-case basis through no-action letters, using criteria similar to those in Regulation S and rule 15a-6.[30]

2. Foreign Advisers and Clients Outside the United States

Under a conduct and effects approach, the Advisers Act generally would not govern the relationship between a registered foreign adviser and its clients residing outside the United States. In this situation, the United States would not have a significant regulatory interest because the relationship would involve neither clients, nor advisory services rendered, within the United States. Also, if a nonresident adviser does not hold itself out to foreign persons as being registered under the Advisers Act, an expectation of protection under the Advisers Act is unlikely.[31] Finally, a foreign regulator would have a much

[29]Under the existing positions, the question arises only in connection in with determining whether a foreign adviser may rely on the exemption in section 203(b)(3) for advisers with fewer than 15 clients. See *supra* note 6.

[30]Regulation S generally deems United States citizens residing abroad **as** outside the protections of the registration requirements of the Securities Act. Rule 902(o) thereof defines "United States person" to include, among others, any natural person resident in the United States, but does not include United States citizens resident abroad. Rule **15a-6** under the Exchange Act (17 C.F.R. § 240.15a-6), adopts an approach similar to that of Regulation S. See Exch. Act. Rel. 27017, *supra* note 7, at III.B.2.

[31]In adopting a conduct and effects approach, the Commission could prevent registered foreign advisers that do not want their activities outside the United States to be governed by the Advisers Act from holding themselves out to foreign clients as being subject to Commission
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greater interest than the United States in regulating investment advice given within its territory to persons located there.

At the same time, the offshore activities of a registered foreign adviser may have a significant effect on United States clients. Abusive practices such as front running and unauthorized principal and agency cross transactions involving the accounts of foreign clients or foreign affiliates could harm United States investors. For example, an adviser might sell a security from a foreign client's account to the account of a United States client without receiving written authorization from the United States client in contravention of section 206(3) of the Advisers Act, which addresses such agency cross-transactions, or place foreign client transactions ahead of a large transaction by a United States client. In our view, the Advisers Act should be applied to such activities because they involve United States clients.

3. Domestic Advisers and Foreign Clients

When a domestic adviser is advising foreign clients, it is likely that a sizable amount of the advisory activity will occur in the United States. Where the investment advice is being provided by a domestic adviser and where its employees providing the advice are based in the United States, the United States has a significant regulatory interest in the activity and application of the Advisers Act is appropriate.

A foreign client doing business with an adviser located in the United States would be justified in expecting the protections afforded by United States law. When a client chooses to deal with advisory personnel located in the United States, the client chooses to have the relationship governed by United States law.[32]

We note that this approach means that a person in a foreign country who seeks the advice of an investment adviser located in the United States would find that the advisory relationship is subject to all the provisions of the Advisers Act. Thus, were a foreign pension fund to hire a domestic investment adviser to manage a portion of its portfolio, all provisions of the Advisers Act would apply

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regulation. *Cf.* IMRO **Rule 16.11 (that advertisements of** IMRO **membership by investment managers for use outside the United Kingdom also must state that the rules and regulations under the United Kingdom's Financial Services Act pertaining** to **investor protection do not apply to those foreign investment managers).**

[32]When **a foreign client deals with advisory personnel located abroad, however, it may be appropriate that the relationship be governed by foreign laws, even if the adviser's main offices are in the United States.**

to that relationship, including the restrictions on performance fees and principal transactions with clients.[33]

4. Multinational Advisers and Foreign Clients

The most difficult questions under the conduct and effects approach would arise with multinational firms, *i.e.*, firms with offices in the United States and at least one other country. A multinational advisory firm may deal with a foreign client with personnel from offices in numerous countries. In the case of such a firm, it will be necessary to determine whether a sizable amount of advisory services takes place in the United States, such that United States regulatory interest is justified. At one extreme, if a foreign client deals exclusively with the foreign office of a multinational firm that has a corporate policy requiring that all portfolio decisions made by that office be formulated by that office, the Advisers Act generally would not apply. At the other extreme, if the client wished to invest in United States markets and dealt exclusively with United States personnel, the Advisers Act would apply. Cases between these extremes may present difficult questions.

Until we have the opportunity to address the difficult questions, we are reluctant to draw definitive lines. The Division expects to provide guidance on a case-by-case basis, where appropriate, through letters. After we have had the opportunity to explore the various questions that necessarily will arise, we will recommend that the Commission codify that approach.

5. Establishing Separate Entities

Adoption of a conducts and effects approach would lessen the need for foreign advisers to organize and register separate entities. Nevertheless, there may be some foreign advisers who, for a variety of reasons, may wish to use a separate registered entity either in the United States or abroad. We believe that it would be consistent with a conduct and effects approach to modify the *Ellis* conditions for the registration of a separate affiliate.

We believe the Commission should recognize separateness if the affiliated companies are separately organized (*e.g.*, two distinct entities), and if the registered entity is staffed with personnel (whether physically located in the

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[33]Section 205(a)(1)'s restrictions on performance fees go beyond those in some other countries, although the section has a limited exception for contracts with investment companies and clients with accounts of $1 million or more, and the Commission has adopted an exemptive rule for certain other contracts with sophisticated clients. Advisers Act rule 205-3, 17 C.F.R. § 275.205-3. In Chapter 6, the Division recommends amending section 205 to permit registered investment advisers to enter into performance fee arrangements with clients not residing in the United States under certain conditions.

United States or abroad) who are capable of providing investment advice. Of course, there would still be a need to evaluate the separate identity of affiliates to ensure that all personnel involved in providing advice to United States persons and all supervisory personnel are subject to Commission jurisdiction. We see no reason to require separate boards, however, nor would we object to the sharing of personnel or communications. To ensure compliance with the Advisers Act, the Commission should require that all personnel involved in United States advisory activities be "associated persons" of the registrant and subject to the supervision of the registrant.[34] In addition, the Commission should have access to trading and other records of the affiliate, and to its personnel, to the extent necessary to monitor and police conduct that may harm United States investors.[35] Thus, we would recommend requirements generally analogous to those in rule 15a-6 under the Exchange Act.[36]

E. Other Alternatives

The Division considered three alternatives to the conduct and effects approach: "nationality," "local law for local clients," and applying the Advisers Act's antifraud provisions, but not its regulatory provisions (such as its recordkeeping requirements), to dealings with foreign clients.

The first alternative, the "nationality" doctrine, postulates that a nation has an interest in applying its law to its citizens, wherever they are located and regardless of where conduct or effects occur. This approach is generally disfavored and has not been extensively applied by the courts.[37] Accordingly, we do not recommend it.

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[34]Under section 202(a)(17) of the Advisers Act, persons associated with an investment adviser include "any partner, officer, or director of such investment adviser (or any person performing similar functions), or any person directly or indirectly controlling or controlled by such investment adviser, including any employee of such investment adviser, . . . [but not] persons . . . whose functions are clerical or ministerial. . . ."

[35]*See supra* text following note 31.

[36]Rule 15a-6 requires, among other things, that an unregistered broker-dealer relying on the rule effect transactions through a registered broker-dealer and that the registered brokerdealer obtain from the foreign broker-dealer certain information required by the broker-dealer recordkeeping rules and a consent to service of process for any civil action brought by or proceeding before the Commission or a self-regulatory organization.

[37]*See* Laker Airways Ltd. v. Sabena Belgian World Airlines, 731 F.2d 909, 934-37 (D.C. Cir. 1984) (rejecting assertion of nationality as the "paramount" basis of jurisdiction); Bersch v. Drexel Firestone, Inc., 519 F.2d at 992 (concluding the antifraud provisions would not be applied solely on basis of nationality to United States nationals residing abroad).

The second alternative, the so-called "local law for local clients" approach, was advocated by a few commenters.[38] Under their approach, the Advisers Act would not apply to a United States adviser's dealings with clients residing outside the United States, even where the advice is formulated and provided by persons residing in the United States.

The arguments in favor of a local law for local clients approach are largely competitive. Supporters say that United States advisers are at a competitive disadvantage because the Advisers Act in some ways is more restrictive than the systems of regulation imposed by many foreign laws, so that, in addition to complying with the laws and regulations of the country in which the client is located, United States advisers have the added burden of complying with the Advisers Act -- a burden not shared by foreign advisers. Thus, for example, United States advisers of foreign clients would not be able to enter into the same types of fee arrangements as foreign advisers.[39]

Although we are sympathetic to the competitive concerns, we believe the local law for local clients approach is inconsistent with the purposes of the Advisers Act, general principles of jurisdiction, and the expectations of investors. In our view, the better approach is to apply the Advisers Act where a domestic adviser's dealings with foreign clients involve a sizable amount of activity *in the United States.*

As the courts have recognized, the United States and the Commission have a strong interest in preventing this country from being used as a base for fraudulent or abusive practices by investment advisers. It is not realistic to expect other countries to police the activities of United States advisers, particularly where those advisers may be conducting only limited solicitation and other marketing activities abroad.

The third alternative, applying only the antifraud provisions of the Advisers Act to dealings with foreign clients and not the regulatory provisions, has some basis under the securities laws. As noted above, in interpreting the scope of the securities laws, courts have indicated that the antifraud provisions

[38] *See, e.g.,* Letter from Cleary, Gottlieb, Steen & Hamilton to Jonathan G. Katz, Secretary, SEC 76 (Oct. 12, 1990), File No. S7-11-90; Dechert Price Study Comment, supra note 25, at 27.

[39] In theory, one effect of the competitive disadvantage might be that investment advisers would be less likely to base their operations in the United States because, while they can serve United States clients by simply registering in this country, they can avoid regulation under the Advisers Act with respect to foreign clients by locating outside the United States. We do not believe this is particularly likely because, among other things, advisers that desire to develop United States market expertise and to deal with United States clients will undoubtedly find it helpful or necessary to have personnel located here.

have wider scope than do other regulatory provisions.[40] Similarly, in adopting Regulation S the Commission determined that the registration provisions of section 5 of the Securities Act generally should not apply to issuers' sales of securities outside the United States, but did not limit the reach of the antifraud provisions.[41]

On balance, however, we generally believe that the Commission should apply all of the Advisers Act to the dealings of United States advisers with foreign clients where a sizable amount of the advisory activity occurs in the United States. Most of the substantive provisions of the Advisers Act are intended as prophylactic means to prevent fraud. In fact, a number of the more important rules under the Advisers Act, including advertising restrictions, custody requirements, and certain disclosure obligations, have been adopted using the authority of section 206(4), which prohibits fraud and gives the Commission the authority to make rules defining fraud and prescribing means reasonably designed to prevent fraud. Determining which of these provisions should have greater or lesser reach would be a difficult and probably fruitless task. We believe that once an investor chooses to deal with a domestic adviser, it would be anomalous to apply only the Advisers Act's antifraud provisions. As discussed in Chapter 6, however, we believe that an exception should be made for section 205's limits on performance fees.

IV. Conclusion

The Division believes the Advisers Act should be applied more narrowly, based on a conduct and effects analysis. Accordingly, the Division intends to provide no-action advice to investment advisers using this approach. After the Division has had the opportunity to explore the various questions that necessarily will arise, the Division will recommend that the Commission codify that approach.

[40] *See supra* note 23 and accompanying text. *See also* Registration Requirements for Foreign Broker-Dealers, Exchange Act Release No. 25801 at nn.42-44 and accompanying text (June 14, 1988), 53 FR 23645.

[41] *See* Sec. Act Rel. 6863, *supra* note 17, at I.