NELSON MULLINS

FinTech and Private Fund Advisers

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Agenda

- Introductions
- What is an Investment Adviser?
- Exclusions from Registration as an Investment Adviser
- What is an Investment Company?
- Exclusions from Investment Company Status
- Private Fund Advisers
- Venture Fund Advisers
- Custody of Digital Asset Securities

What is an Investment Adviser?

- Section 202(a)(11) of the Advisers Act defines an "investment adviser" as any person or firm that:
  - For compensation;
  - Is engaged in the business of;
  - Providing advice to others or issuing reports or analyses regarding securities.
- A person must satisfy all three elements to fall within the definition of an investment adviser.

Compensation

- A person must receive compensation for giving investment advice to be an investment adviser.
- The term “compensation” has been broadly construed.
- Generally, the receipt of any economic benefit, whether in the form of an advisory fee, some other fee relating to the total services rendered, a commission, or some combination, satisfies this element.
- It is not necessary that a client “pay a discrete fee specifically earmarked as payment for investment advice.”
- The compensation element is satisfied even if payments cover only the cost of the services.
- It does matter “whether the person receiving the advice or another person is paying the compensation.”

Engaged in the Business

- A person must be engaged in the business of providing advice about securities to be an investment adviser.
- Factors used to evaluate whether a person is engaged in the business are: (i) whether the person holds himself out as an investment adviser; (ii) whether the person receives compensation that represents a clearly definable charge for providing investment advice; and (iii) the frequency and specificity of the investment advice provided.
- Generally, a person providing advice about specific securities will be deemed to be "engaged in the business" unless specific advice is rendered only on a rare or isolated occasion.
- The SEC staff views a person as engaged in the business if he holds himself out as an adviser.
- Such actions include advertising as an "investment adviser," investment manager or financial planner, using letterhead indicating activity as an investment adviser, or maintaining a telephone listing or otherwise letting it be known that he will accept new advisory clients, hiring a person to solicit clients on his behalf, or making information about himself generally available on the internet.

Advising About Securities

- To be deemed an investment adviser a person must also be advising others about securities. A person meets the third element of the statutory test if he provides advice about specific securities, such as stocks, bonds, mutual funds, limited partnerships, and commodity pools.

- Advice about securities includes:

  - Advice about market trends;
  - Advice about the selection and retention of other advisers;
  - Advice about the advantages of investing in securities versus other types of investments (e.g., coins or real estate);
  - Providing a selective list of securities even if no advice is provided as to any one security;
  - Advising about the value of securities;
  - Asset allocation advice; and
  - Advice about voting proxies.

Advising About Securities

- A person managing a fund investing in securities, such as a mutual fund or a hedge fund, is advising others even where the person is the general partner with legal title to these assets.

- The SEC staff has taken the position that providing information about securities in a report does not constitute providing advice about the securities if:

  - the information is readily available to the public in its raw state;
  - the categories of information presented are not highly selective; and
  - the information is not organized or presented in a manner that suggests the purchase, holding, or sale of any security.

Exclusions

- There are several exclusions from the investment adviser definition available to persons who presumably (or at least arguably) satisfy all three elements of the definition.
  - Banks and Bank Holding Companies
  - Lawyers, Accountants, Engineers, and Teachers
  - Brokers and Dealers
  - Publishers
  - Government Securities Advisers
  - Credit Rating Agencies
  - Family Offices
  - Governments and Political Subdivisions
  - Non-U.S. Advisers
- The SEC has authority to designate, by rule or order, other persons who are not within the intent of the definition of investment adviser.

What is an Investment Company?

- The Investment Company Act of 1940 (the "Investment Company Act") defines an "investment company" to include any issuer which:
- Is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
- Is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
- Is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on a diluted basis.
- This definition is designed to include businesses that manage, sell, and market funds based in securities, including loans that may be deemed to be securities.
- Generally, an investment company invests the money it receives from investors on a collective basis, and each investor shares in the profits and losses in proportion to the investor's interest in the investment company.
- If an entity fits the definition of an investment company under the Investment Company Act, absent an exemption, it is subject to requirements and obligations of the Investment Company Act.

Exemptions

- Section 3(b)(1) of the Investment Company Act excludes some issuers from the definition of investment company if they are primarily engaged in a business other than investing, reinvesting, holding, or trading securities.

- Section 3(c)(1) of the Investment Company Act excepts from the definition of investment company any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and that is not making and does not at that time propose to make a public offering of such securities.

- The term “public offering,” as used in Section 3(c)(1) has the same meaning that it has in Section 4(2) of the Securities Act.

- Under Section 4(2) , which exempts from registration transactions by an issuer not involving any public offering, “Whether a transaction is one not involving any public offering is essentially a question of fact and necessitates a consideration of all surrounding circumstances, including such factors as the relationship between the offerees and the issuer, the nature, scope, size, type and manner of the offering.”

- Section 3(c)(7) excepts from the definition of investment company any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers and that is not making and does not at that time propose to make a public offering of such securities.

Private Fund Advisers

- Available to an adviser (i) solely to private funds that have less than $150 million in assets under management in the United States, and (ii) one or more small business investment companies (SBICs) (discussed below).
- An adviser that has any other type of client is not eligible for the exemption.
- Private Funds
- A “private fund” is an issuer of securities that would be an investment company “but for” the exceptions provided for in section 3(c)(1) or 3(c)(7) of the Investment Company Act.
- Section 3(c)(1) is available to a fund that does not publicly offer its securities and has 100 or fewer beneficial owners of its outstanding securities.
- Section 3(c)(7) is available to a fund that does not publicly offer its securities and limits its owners to “qualified purchasers,” which generally include natural persons who own at least $5 million in investments.
- Private funds typically rely on the safe harbor provided by Regulation D under the Securities Act of 1933 to offer their securities in “private placements,” which precludes general solicitations, e.g., advertisements and other public statements.
- In 2013, the SEC adopted amendments to Regulation D that permitted issuers including private funds, subject to certain conditions, to make general solicitations.

Private Fund Advisers

- A private fund is disqualified from making an offering in reliance on section 506 of Regulation D if, among other persons, an investment adviser to a private fund issuer (or certain of its directors and officers) has engaged in certain "disqualifying conduct" during the past 10 years.

- Most private funds making offerings in the United States rely on section 506.

- Disqualifying conduct includes convictions within the last 10 years (in some cases 5 years) for securities fraud; being subject to certain injunctions or decrees by courts and regulators involving securities, banking, insurance of commodities activities; suspension or expulsion from membership by a self-regulatory organization (such as FINRA), etc.

Private Fund Advisers

- Less than $150 million in AUM in the United States.
- In determining whether it has less than $150 million in assets under management in the United States:
- U.S. Advisers
- An adviser that has its principal office and place of business in the United States is deemed to manage all of its assets in the U.S. even if the adviser has offices outside the U.S. at which management activities take place.
- Non-U.S. Advisers. An adviser with a principal office and place of business outside the United States (i) must include only assets managed at a "place of business" in the U.S., and (ii) may exclude consideration of assets managed on behalf of non-U.S. clients.
- As a result a non-U.S. adviser may rely on the exemption if: (A)all of its clients that are U.S. persons are private funds (even if some or all non-U.S. clients are not); and (B) management activities in the United States are limited to $150 million of private fund assets.
- A non-U.S. adviser's non-U.S. clients will not count in determining whether it qualifies for the private fund adviser exemption as long as the assets of the non-U.S. clients are managed from outside the United States.
- The exemption is available regardless of where the private fund is organized.

Private Fund Advisers

- Calculating Private Fund Assets
- Generally, advisers must include the value of all private funds managed, including the value of any uncalled capital commitments.
- Value is based on market value of those assets, or the fair value of those assets where market value is unavailable, and must be determined on a gross basis, i.e., without deduction of any liabilities, such as accrued fees and expenses or the amount of any borrowing.
- Annual Assessment
- An adviser relying on the private fund exemption must assess annually whether it has $150 million or more of private fund assets under management. An adviser that meets or exceeds the $150 million threshold must register with the SEC.
- However, accepting an engagement with a client that is not a private fund will cause the adviser to immediately lose the exemption and require it to be registered.

Private Fund Advisers

- Advisers Act Lite
- Alternatively, a non-U.S. adviser managing a private fund organized outside of the United States may register as an investment adviser under the Advisers Act.
- Most of the substantive provisions would be inapplicable to the adviser with respect to the private funds under the Unibanco line of SEC staff no action letters.
- This alternative permits the adviser to accept U.S. clients that are not private funds, e.g., separate accounts, with respect to which the adviser would be subject to all of the provisions of the Advisers Act.

Private Fund Advisers

- Annual Reporting and Examination

- An adviser relying on the private fund adviser exemption must file an initial and annual report on Form ADV to the SEC and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply.

- The SEC refers to these advisers as “exempt reporting advisers.”

Venture Capital Advisers

- Available to an adviser that solely advises (i) one or more "venture capital funds" as defined by SEC rule (regardless of the amount of assets managed), and (ii) one or more SBICs (discussed below).158 a. Venture Capital Fund.

- To qualify as a "venture capital fund," a fund must be a "private fund" that:

  - Represents to investors that the fund pursues a venture capital strategy;
  - Does not provide investors with redemption rights;
  - Holds no more than 20% of its assets in non-"qualifying investments" (excluding cash and certain short-term holdings); and
  - Does not borrow (or otherwise incur leverage) more than 15% of the fund's assets, and then only on a short-term basis (i.e., for no more than 120-days).

- Qualifying investment generally means directly acquired investments in equity securities of private companies (generally, companies that at the time of investment have not made a public offering) that do not incur leverage or borrow in connection with the venture capital fund investment and distribute proceeds of such borrowing to the fund (i.e., have not been acquired in a leveraged buyout transaction).

Venture Capital Advisers

- Non-U.S. Advisers
- The exemption is available to a non-U.S. adviser, but (unlike the private fund adviser exception) such an adviser may not disregard its non-U.S. advisory activities.
- Thus, all of an adviser's clients, including non-U.S. clients, must be venture capital funds.
- Annual Reporting and Examination
- An adviser relying on the venture capital adviser exemption must annually file a report on Form ADV to the SEC,166 and is subject to examination. Other provisions of the Act and SEC rules applicable only to registered advisers do not apply.
- The SEC also refers to these advisers as "exempt reporting advisers."

Custody of Digital Asset Securities

- The SEC has defined digital assets as “an asset that is issued and transferred using distributed ledger or blockchain technology”.
- Digital assets include, but are not limited to, virtual currencies, coins, and tokens.
- A digital asset may in certain instances be deemed a security under the federal securities laws.
- While not defined in the securities laws, the SEC often refers to digital assets that are securities as “digital asset securities”.
- Digital assets are stored by associating them with addresses called “wallets” which can be stored on web servers, local hardware like personal computers, jump drives and mobile devices, or on paper print-outs.
- A digital asset wallet takes the form of a cryptographic public key, which is a string of numbers and letters.
- Each public key has a matching “private key”, known only to the user.
- The question of the custody of digital assets that are securities presents substantial problems for firms registered with the SEC as an investment adviser or a broker-dealer.

Digital Asset Securities

- The definitions of "security" under the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act") are virtually identical and each is broad enough to include the various types of instruments that are used in commercial marketplaces that one might suspect to fall within the ordinary concepts of a security.

- This includes common instruments like stocks, bonds, and notes, as well as the various collective investment pools and common enterprises devised by persons seeking to generate profits from the efforts and investments of others (i.e., investment contracts and instruments commonly known as securities).

- The definitions of security under the Securities Act, the Exchange Act, the Investment Advisers Act of 1940 (the "Advisers Act"), and the Investment Company Act of 1940, do not include currencies.

- However, the SEC has argued that investments in digital asset-related schemes are investment contracts – a contract, transaction, or scheme involving (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation that profits will be derived from the efforts of the promoter or a third party.

- When digital assets that have been issued are securities, the custody of such securities by investment advisers and broker-dealers registered with the SEC will require the application of existing securities laws that address custody and protection of customer funds and securities.

Custody Rule

- A registered adviser with custody of client funds or securities ("client assets") is required by Rule 206(4)-2 of the Advisers Act (the "Custody Rule") to establish a set of controls to safeguard those assets.

- Custody means "holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them".

- An adviser is deemed to have custody if an affiliate has custody of its client funds or securities in connection with advisory services it provides to clients.

- Custody includes:

  - physical possession of client funds or securities;
  - any arrangement under which an adviser is permitted or authorized to withdraw client funds or securities (such as check-writing authority or the ability to deduct fees from client assets); and
  - any capacity that gives an adviser or its supervised person legal ownership of or access to client funds or securities.

- An investment adviser is deemed to have custody if it or a related person holds, directly or indirectly, client funds or securities, or has any authority to obtain possession of them.

Qualified Custodian

- An adviser with custody must maintain client funds and securities with a qualified custodian either under the client's name or under the adviser's name as agent or trustee for its client.

- A qualified custodian is a federally insured bank or savings association, a registered broker-dealer, a registered futures commission merchant (with respect to client funds and security futures), or a foreign financial institution that customarily holds financial assets for its customers.

- A "bank" is defined as:

  - a banking institution organized under the laws of the United States or a federal savings association;
  - a member bank of the Federal Reserve System; or
  - any other banking institution, savings association, or trust company, whether incorporated or not, doing business under the laws of any state or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is supervised and examined by state or federal authority having supervision over banks or savings associations.

- The qualified custodian must send an account statement at least quarterly to each client, and client funds and securities must be verified at least annually by an independent public accountant.

Custody

- Client assets that are not cash or securities need not be maintained with a qualified custodian.
- Two types of securities are not required to be maintained with a qualified custodian:
- Shares of mutual funds held with the fund's transfer agent; and
- Privately offered securities (i.e., uncertificated securities acquired in a private placement that are recorded in the name of the client only on the books of the issuer or its transfer agent and transferrable only with the consent of the issuer).
- The SEC has deemed client digital assets that are not securities to be client funds.

Custody of Digital Assets

- On March 12, 2019, the staff of the SEC Division of Investment Management (the "Division") published a letter seeking input from investment advisers, other market participants, and the public regarding the application of the Custody Rule to digital assets.

- That letter was a response to issues raised by investment advisers and other market participants following the publication of SEC Guidance on the issue in 2017.

- In the letter, the SEC staff noted digital assets are subject to the Custody Rule if they are either "funds" or "securities" and if the registered investment adviser has any authority to obtain possession of them.

- On January 18, 2018, the Director of the Division sent a letter to the Investment Company Institute and the Securities Industry Financial Markets Association, captioned "Engaging on Fund Innovation and Cryptocurrency-related Holdings".

- In the letter, the SEC staff noted:

  We appreciate that proponents of cryptocurrencies and related products have identified a range of potential benefits. ... [T]he innovative nature of cryptocurrencies and related products, as well as their expected use and utility in our financial markets, means that they are, in many ways, unlike the types of investments that registered funds currently hold in substantial amounts.

- In the letter, the Division requested information on several investor protection issues before sponsors begin offering these funds to retail investors, including the custody of digital assets that are securities.

- The Division noted the Advisers Act requires the use of safeguards to ensure that registered funds maintain safe custody of their holdings custodian.

SEC Crypto Task Force

Commissioner Hester Peirce will lead agency-wide effort

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Washington D.C., Jan. 21, 2025 — Today SEC Acting Chairman Mark T. Uyeda launched a crypto task force dedicated to developing a comprehensive and clear regulatory framework for crypto assets. Commissioner Hester Peirce will lead the task force. Richard Gabbert, Senior Advisor to the Acting Chairman, and Taylor Asher, Senior Policy Advisor to the Acting Chairman, will serve as the task force's Chief of Staff and Chief Policy Advisor, respectively.

Drawing from talented staff across the agency, the Task Force will collaborate with Commission staff and the public to set the SEC on a sensible regulatory path that respects the bounds of the law. To date, the SEC has relied primarily on enforcement actions to regulate crypto retroactively and reactively, often adopting novel and untested legal interpretations along the way. Clarity regarding who must register, and practical solutions for those seeking to register, have been elusive. The result has been confusion about what is legal, which creates an environment hostile to innovation and conducive to fraud. The SEC can do better.

The Task Force's focus will be to help the Commission draw clear regulatory lines, provide realistic paths to registration, craft sensible disclosure frameworks, and deploy enforcement resources judiciously.

The Task Force will operate within the statutory framework provided by Congress and will coordinate the provision of technical assistance to Congress as it makes changes to that framework. The Task Force will coordinate with federal departments and agencies, including the Commodity Futures Trading Commission, and state and international counterparts.

"I look forward to the efforts of Commissioner Peirce to lead regulatory policy on crypto, which involves multiple SEC divisions and offices," said Acting Chairman Uyeda.

"This undertaking will take time, patience, and much hard work. It will succeed only if the Task Force has input from a wide range of investors, industry participants, academics, and other interested parties. We look forward to working hand-in-hand with the public to foster a regulatory environment that protects investors, facilitates capital formation, fosters market integrity, and supports innovation," stated Commissioner Peirce.

The Task Force anticipates holding roundtables in the future, but in the meantime welcomes public input at Crypto@sec.gov.

Contact Details

To learn more about our FinTech and Regulation practice, or to contact a member of our team, click here or visit our website at nelsonmullins.com.

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Moderator Biography

RICHARD B. LEVIN

Richard is chair of the FinTech and Regulation Practice and was one of the first lawyers to focus on the regulation of blockchain and digital assets. He is considered a thought leader in the FinTech space. Richard brings his experience as a senior legal and compliance officer on Wall Street and in London to bear in advising clients on corporate, FinTech, securities, and regulatory issues. A problem-solver by nature, he has been advising FinTech clients on legal and regulatory issues since the start of electronic trading in the late 1990s. His practice focuses on helping financial services and technology clients identify and address regulatory issues as they build their businesses.

Richard's practice focuses on the representation of early stage and publicly traded companies in the FinTech space, including investment banks, broker-dealers, investment advisers, peer-to-peer lending platforms, digital currency trading platforms, alternative trading systems (ATSs), exchanges, and custodians. He represents these firms before the U.S. Securities and Exchange Commission (SEC), the U.S. Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), the U.S. Department of the Treasury, Office of the Comptroller of the Currency (OCC), state regulators, and Congress. Richard has represented clients before regulators in Australia, Canada, France, Germany, Hong Kong, Ireland, Japan, Singapore, South Korea, and the United Kingdom. His current and past clients include leading national financial institutions, multinational financial services holding companies, leading firms in the FinTech space, and institutions engaging in global investment banking, investment management, securities, and other financial services with institutional clients.

Richard has been identified by Chambers and Partners as one of the leading lawyers in the Blockchain and Cryptocurrencies category since the inception of the category. He has been recognized by Chambers for his knowledge on regulatory matters, great relationships with regulators, for helping clients push the boundaries of the FinTech sector, and for his advice on matters such as broker-dealer licensing and alternative trading systems. Richard is routinely quoted by leading publications including Bloomberg, the New York Times, Reuters, and the Wall Street Journal and is a frequent speaker at conferences around the world on the regulation of FinTech, blockchain, and digital assets.

Speaker Biographies

Arina Shulga

Arina represents startups and emerging growth companies, often acting as their outside general counsel and building long-lasting relationships that span the life of a company. Her services in this area include, but are not limited to, entity formation, advice and counseling regarding operations in the United States, employment law and IP-related matters, structuring complex joint ventures and distribution agreements, and investment and exit opportunities. Further, Arina represents her clients when they are raising capital through SAFE, convertible note, Series Seed, Series A financings, and equity crowdfunding.

An important focus of Arina's work is representing fintech startups, including those companies that operate in the blockchain space (including NFT platforms, DAOs, gaming companies, and others). For her crypto clients, she advises on the regulatory aspects of operations, issuance of digital tokens, NFTs, creation of platforms, and other aspects of operations in the Web3 space. She also advises angel investors and venture capital funds when making investments into startups.

In addition, Arina represents emerging fund managers on fund formation and setting up management and GP company structures, whether they are in the venture capital, hedge fund, or real estate fund space, including special purpose investment vehicles and Delaware series LLCs.

Speaker Biographies

Audra White

Audra's practice focuses on the formation and representation of private investment funds and their sponsors within a broad range of strategies and industries, including venture, growth, real estate, energy, digital assets, buyout, as well as hedge funds. She also advises sponsors on seed arrangements with anchor investors, "funds of one", co-investments, spinouts, internal governance, equity incentive structures and other upper tier matters and regulatory compliance.

In addition, Audra frequently advises investors with the structuring and negotiation of special purpose investment vehicles, joint ventures, and other bespoke investment structures.

Audra's passion is helping both emerging and established investment teams efficiently navigate today's commercial and regulatory environment in order to successfully launch and grow their businesses.