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Client Alert

Investment Management

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When Two Become One: Navigating the Complexities of Operational Integration

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On September 20, 2024, the U.S. Securities and Exchange Commission (SEC) announced a settlement with an investment adviser for, among other things, failure to register with the SEC as an investment adviser. The SEC found that the unregistered investment adviser was "operationally integrated" with its SEC-registered affiliate such that the two entities should have been treated as one for purposes of determining registration requirements.

As shown by this settlement and prior ones, discussed below, this issue continues to be on the SEC's radar. In light of this recent SEC enforcement action, we examine the concept of operational integration and review various related enforcement actions.

Overview of Private Fund Exemptions and Operational Integration

The SEC states that it will treat multiple advisers as one if the advisers are "separately organized but operationally integrated."[1] Issues relating to operational integration can occur in instances where both advisers are claiming exemptions or where one adviser is claiming a registration exemption and the other is already registered. Operationally integrated advisers must aggregate the assets they manage when determining if they qualify for the exemption. This means, for example, that if either (1) an adviser is relying on the private fund adviser exemption and the combined assets under management exceed the $150 million threshold or (2) an adviser is relying on the venture capital fund adviser exemption and one of the adviser entities does not qualify for the venture capital exemption, both advisers are required to register. In addition to this, we have seen the SEC comment on domestic advisers and their affiliated foreign advisers (which, under certain circumstances, may utilize a participating affiliate arrangement) as well as advisers and their affiliated family offices.

The SEC notes that whether separately formed affiliate advisory businesses need to be treated as operationally integrated is based on the specific facts and circumstances.[2] In the 1981 Richard Ellis No-Action Letter,[3] the SEC discusses certain factors relevant to the determination of whether a separately formed advisory entity operates independently of an affiliate. These factors include whether the adviser:

1. Is adequately capitalized
2. Has a buffer between the subsidiary's personnel and the affiliate, such as a board of directors, a majority of whose members are independent of the affiliate;
3. Has employees, officers, and directors who, if engaged in providing advice in the day-to-day business of the subsidiary, are not otherwise engaged in the investment advisory business of the affiliate
4. Itself makes 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 investment information not limited to its affiliate
5. Keeps its investment advice confidential until that advice is communicated to its clients

The SEC uses the factors laid out in the Richard Ellis No-Action Letter in most of its subsequent actions regarding potential circumstances of operational integration. As seen in the enforcement actions below, the SEC conducts a thorough, fact-based analysis in determining whether advisers are operationally integrated, focusing on the specific details of their operation.

Recent SEC Enforcement Case

In September 2024, the SEC announced settlement with an investment adviser that, prior to the settlement, filed as an exempt reporting adviser (Adviser 1) that was found to be operationally integrated with a registered affiliate (Adviser 2), resulting in Adviser 1 being required to register with the SEC.

The settlement found that Adviser 1 and Adviser 2 had overlapping owners, managers, advisory personnel, and operations, including shared office space, without policies or procedures in place to ensure separation of the two advisers. Because of these factors, the advisers were deemed operationally integrated and should have been treated as a single adviser when making the determination of whether each adviser needed to register.

According to the settlement, because the operationally integrated enterprise did not solely advise private funds but also advised individuals, and because the operationally integrated enterprise had combined regulatory assets under management that exceeded the threshold for SEC registration, Adviser 1 did not qualify for the private fund exemption and should have registered as an investment adviser.

The SEC's analysis showed that it takes a fact-based inquiry into the question of whether advisers are operationally integrated. The mere legal separation of entities is not enough to avoid registration requirements if the advisers' activities are in fact sufficiently intertwined.

Previous SEC Settlements on Operational Integration

This latest enforcement action is consistent with prior SEC rulings on operational integration. In prior actions, the SEC found that two or more advisers were operationally integrated when they shared resources, coordinated investment strategies, or operated in ways that suggested they were, in practice, a single advisory business.

Settlement 1

In 2014, the SEC announced a similar settlement regarding operational integration.[4,5] Adviser A had been relying on the venture capital adviser exemption, and in its exempt reporting adviser report on Form ADV, reported regulatory assets under management of approximately $178 million in venture capital funds. Adviser B was relying on the private fund adviser exemption and reported, in its exempt reporting adviser report on Form ADV, $51 million in regulatory assets under management. The settlement noted that the two advisers, while structured as separate entities, were operationally integrated.

On their exempt reporting adviser reports filed with the SEC, both Adviser A and Adviser B reported that they were under common control. Various employees and associated persons of Adviser A held ownership stakes in Adviser A and also in the general partner and management company entities of Adviser B.

The advisers had several overlapping employees and associated persons, including individuals who provided investment advice on behalf of both advisers. For example, two of the three members of Adviser B's investment committee, which had sole and exclusive authority to approve any investment by Adviser B's fund, also served as managing directors at Adviser A and were significantly involved in providing investment advice on behalf of Adviser A.

The SEC noted that Adviser A and Adviser B had significantly overlapping operations without any policies and procedures designed to keep the entities separate. Further, marketing materials for Adviser B made reference to Adviser A and Adviser B as being a "partnership" and referenced Adviser B's ability to leverage and benefit from this relationship, including outsourcing its back-office functions to Adviser A.

Despite the advisers' nominal independence, the SEC determined that their operations were sufficiently intertwined and the advisers should have been integrated as a single investment adviser for purposes of registration requirements or

determining the applicability of any exemption. Because of this, neither adviser qualified for the exemption on which it had been relying. When aggregating the advisers, Adviser A did not solely advise venture capital funds as required by the venture capital adviser exemption, and Adviser B exceeded the $150 million maximum in assets under management required to rely on the private fund adviser exemption.

Settlement 2

In 2017, the SEC also announced a settlement with respect to operational integration.[6] Adviser Y was a registered investment adviser, and Adviser Z claimed to be exempt from registration based on the private fund adviser exemption. Adviser Y and Adviser Z had the same managing member, sole owner, and chief compliance officer (Managing Member). Adviser Y and Adviser Z also shared office space and technology systems.

From 2006 until 2013, Adviser Y, the registered investment adviser entity, was the investment adviser to a private fund (Fund). The SEC notes that in 2013, after consulting with a compliance consultant, the Managing Member formed Adviser Z after learning that Adviser Y would not have to comply with certain Advisers Act rules in advising a private fund if the Fund was instead advised by an exempt reporting adviser (Adviser Z). The Managing Member did so in an effort to save on expenses by not having to obtain an audit for the Fund or a surprise examination to comply with the Custody Rule.[7]

In its settlement, the SEC emphasized that the advisers were intertwined in critical aspects. The common ownership–coupled with a shared office and the same technology systems, principal place of business, and overlapping personnel and resources–made the advisers operationally integrated. The SEC determined that because Adviser Z was operationally integrated with Adviser Y, a registered investment adviser, Adviser Z was required to be registered with the SEC.

In all of these settlements, the SEC's decisions were based on the factual realities of the advisers' operations rather than on their legal or corporate structure. These settlements reflect the SEC's long-standing concern that private fund advisers might attempt to structure themselves in a way that circumvents registration requirements, while still effectively operating as a single business.

Key Takeaways

Advisers should remain cognizant of operational integration, especially as they establish new advisory entities, enter into business relationships with other advisers or form related family offices, or engage in new ventures, whether foreign or domestic. Since the SEC applies a fact-based analysis to determine whether advisers are operationally integrated, it is essential to carefully assess the facts and circumstances of each arrangement between adviser entities.

Even when advisers believe they are operating as separate entities, shared personnel, joint decision-making, use of common resources, and other factors all can contribute to the SEC determining that the advisers are operationally integrated. The SEC also looks for schemes to evade the requirements of the Advisers Act, and legal separation may not suffice if the advisers' operations are intertwined.

Please contact any of the listed authors of this Client Alert or your usual Lowenstein Sandler contact if you have any questions with respect to this settlement, operational integration, or any other related legal or compliance matters.

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[1] Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 at 125 (June 22, 2011).
[2] https://www.sec.gov/files/rules/final/2011/ia-3222.pdf at Page 125.
[3] Richard Ellis, Inc., SEC Staff No-Action Letter (Sept. 17, 1981)
[4] https://www.sec.gov/files/litigation/admin/2014/ia-3859.pdf.
[5] https://www.sec.gov/files/litigation/admin/2014/ia-3858.pdf.
[6] https://www.sec.gov/files/litigation/admin/2017/ia-4733.pdf.
[7] Rule 206(4)-2

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