

Fund Managers Required to Register As Investment Advisers – Bruce E. Methven

For a long time managers of many funds were not required to register as investment advisers. This is changing and fund managers (or would-be fund managers) now have a number of important requirements to meet. The changes affect funds that invest in other funds or that purchase securities – which may well include promissory notes (even those secured by deeds of trust). The impact can be especially great on fund managers with funds of fewer than 100 investors. If you're such a fund manager, grab a cup of coffee (or better yet, a glass of wine) and bear with me.

Some brief history is helpful. Up until the Dodd-Frank Act went into effect, on the federal level a fund manager did not have to register as an investment advisor if 1) the manager had fewer than fifteen clients (a fund was counted as a single client) and 2) neither held himself/herself/itself out generally to the public as an investment adviser nor acted as an investment adviser to any investment company. The states generally allowed that same exemption.

Due to fraud by some fund advisors, Dodd-Frank eliminated that exemption, but a federal regulation provides an exemption for a fund manager who (1) acts solely as an investment adviser to one or more qualifying private funds; and (2) manages private fund assets of less than \$150 million. (17 CFR § 275.203(m)–1. There is also an exemption for advisors who advise only venture-capital funds.) A qualifying private fund, also known as a 3(c)(1) fund, is defined as “Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities.” (15 U.S.C. § 80a–3(c)(1). These funds are also excluded from the definition of “investment company”.) The advisers who qualify are called “exempt reporting advisers.” They are exempt from federal registration but must still provide reports to the SEC and maintain certain records. (See <http://www.sec.gov/rules/final/2011/ia-3308.pdf>; Form ADV is required but Form PF is not.)

So far, so good. But rather than following the 3(c)(1) exemption, the North American Securities Administrators Association (NASAA) adopted a different proposed Model Rule for the states on December 16, 2011. (NASAA is the organization of state securities regulators.) The Model Rule requires partial registration as an investment advisor for fund managers who manage at least one qualifying fund. (There is an exception for venture-capital funds that actively manage other operating companies.) The NASAA Model Rule also requires that the fund manager allow only “qualified clients” into the fund.

For individuals to be “qualified clients” they must have either \$1 million in investments managed by the adviser or at least \$2 million in net worth. (Further, the model rule requires that the fund manager issue audited financials each year, which is quite expensive for small funds.)

At this point you may be asking yourself “How can the states do this when federal Rule

506 allows sales of securities to accredited investors and sophisticated investors and Rule 506 preempts state law?” It’s an excellent question and one that will likely be litigated at some point.

A number of states have already adopted the NASAA Model Rule, though often with variations. (These include California, Indiana, Maine, Massachusetts, Michigan, Rhode Island, Virginia, and Wisconsin.)

The latest to do so is California, which issued regulations effective August 27, 2012. One of California’s variations is that the funds must be limited to accredited investors. (There is a provision that allows funds to keep non-accredited investors who invested prior to August 27, 2012.) Obviously that’s better than the NASAA qualified-client standard, but it still eliminates sophisticated investors. (Not to mention pre-existing substantive relationship investors under a California 25102(f) offering and “half-accredited” investors for corporations under a California 25102(n) offering.) It also calls for annual audited financials (and disclosure of the services and duties, etc. owed to investors) even for funds with fewer than 100 investors.

Still, California Corporations Code §25009(a) defines “investment adviser” as one who advises others regarding “securities”. It’s generally accepted that an adviser to a fund – even one who is a fund manager – is not an investment adviser to any investor in the fund because the adviser is not offering individual investment advice to the investor. (See, e.g., *Goldstein v. SEC*, 451 F.3d 873, 879-880 (D.C. Cir. 2006).) So if a fund isn’t buying “securities” then the investment-adviser rules shouldn’t apply. (It doesn’t matter that the fund is selling its own ownership interests or promissory notes, since the fund manager is advising the fund on operations, and is not giving individualized advice to investors. Note, though, that the fund still must make full disclosure to all potential investors regarding its operations and plans.)

“Securities” definitely covers ownership interests in another company and most promissory notes issued by another company or person. Still, under California law, when a fund buys 100% ownership of real property, it is not buying securities. (Partial ownership interests in certain situations could constitute securities.) In other words, managers of California real-estate funds that buy 100% ownership of real property should be exempt from the new California investment-adviser regulations.

In addition, under California law a single-owner, interest-only promissory note (having no equity kicker or profit participation) that is fully secured is not a security. (See, e.g., *People v. Figueroa* (1986) 41 Cal.3d 714, 737.) (Fractionalized or percentage ownership interests in a note or notes with anything other than just interest are securities.) Even if a fund manager gives advice to a fund about buying fully secured, single-owner, interest-only notes, that advice presumably does not regard securities. (It would be different, of course, if the adviser were giving advice to the fund about buying stock or other interests in other companies.)

Unfortunately, the California Department of Corporations so far is taking the position that all promissory notes constitute securities. Given this, the DOC position is that any

fund manager that purchases promissory notes for the fund, even if they are single-owner, interest-only and fully secured by deeds of trust, must comply with the new California rules regarding investment advisers. (The same is true of any fund that invests in other funds or purchases other types of securities.) As a result, managers of such funds must consider themselves bound by the new California rules until further notice.

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For more information on securities laws, head to Background on the Securities Laws: http://thecaliforniasecuritiesattorneys.com/?page_id=41

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