Real Estate Investment Advisers:

A Guide to California and Federal Law

Presented to CalALTs

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Objectives for this Presentation

- Summarize and explain how Federal and State investment adviser regulations affect real estate promoters.
- Summarize the similarities and differences between Federal and State investment adviser registration.
- Identify common pitfalls that could trigger investment adviser registration.
- Discuss the practical consequences of investment adviser registration.

Real Estate Interests and Securities

- An individual or company can hold an ownership, lease, license or easement interest in real property.
- Most investors do not hold one of the foregoing interests directly, but rather hold such interests through one or more special purpose vehicles:
    - SPVs are simply companies set up for a specific limited purpose, such as directly or indirectly holding an interest in real estate
    - SPVs can be corporations, partnerships (general or limited) or LLCs. LLCs and LPs are the most common because:

Structure of a Real Estate Investment

- Pass through taxation.
- Ease of set-up and management.
- Limited liability to Investors.

- As a result, investors in SPVs are holding shares, membership interests, or partnership interests in a company, not an interest in real estate.
- Advisers to SPVs that invest in real estate investors earn fees, often including a carried interest, for managing that investment.

Federalism

- The Federal and State Governments divide the regulation of Investment Advisers:
    - Federal regulation pre-empts state regulation, but only some investment advisers are regulated by Federal law.

Sources of Law

- **Statues**: law passed by a legislature and signed into law by the executive. Can be referenced by name (i.e., The Investment Advisers Act of 1940 (hereafter, the "**Advisers Act**") or the Corporate Securities Law of 1968 (hereafter, the "**CSL**") or by reference to the appropriate section of the applicable code.
    - The Advisers Act is codified at Title 15, Chapter 2D, Subchapter II of the United States Code.
    - The CSL is codified at Title 4, Division 1 of the California Corporations Code.

- **Regulations**: rules promulgated by a regulator (either an independent regulatory agency, such as the SEC, or the California Commissioner of Corporations) pursuant to powers vested in them by statute.
  - Regulations have the force of law and, for our purposes, are indistinguishable from statutes.
  - The regulations promulgated by the SEC for investment advisers pursuant to the Advisers Act are set forth at Title 17, Chapter II, Part 275 of the Code of Federal Regulations.
  - The regulations promulgated by the California Commissioner of Corporations for

investment advisers pursuant to the CSL are set forth at Title 10, Chapter 3, Subchapter 2 of the California Code of Regulations.

- **Case Law**: decisions of state and federal courts applying the statutes and regulations to particular cases.
  - SEC v. Howey Co., 328 U.S. 293 (1946) is the seminal case defining an "Investment Contract" as the term is used in the Securities Act of 1933, as amended, and, by implication, in the Advisers Act.
  - Case law is generally less important than statutes and regulations for investment advisers.

Legal Overview

- **Advisory Opinions**: No action letters and Commissioner's Opinions.
  - Letters issued by regulators in response for a request for guidance on specific facts and circumstances.
  - Can have practical value as a guidepost but are highly fact specific.

California Law

California Law

- Investment Advisers are regulated by The Broker-Dealer and Investment Adviser Division of the California Corporations Commissioner (https://dfpi.ca.gov/broker-dealers-state-investment-advisers-and-sec-investment-advisers).
- The California statue governing investment advisers is codified at Title 4, Division 1 of the California Corporations Code.
- The regulations promulgated by the California Commissioner of Corporations for investment advisers

California Law

is set forth at Title 10, Chapter 3, Subchapter 2 of the California Code of Regulations.

Who Must Register?

- **Operative Provision** (Cal. Corp. Code §25230): (a) It is unlawful for **any investment adviser** to conduct business **as an investment adviser** in this state unless the investment adviser has first applied for and secured from the commissioner a certificate, then in effect, authorizing the investment adviser to do so. . . .
    - **Definitions**: "**Investment adviser**" (Cal. Corp. Code §25009) means **any person** who, for compensation, engages in the business of advising others, either directly or through publications or

writings. . . as to the advisability of investing in, purchasing or selling **securities** . . . .

- **Definition**: "**Person**" (Cal. Corp. Code §25013) means an individual, a corporation, a partnership, a limited liability company, a joint venture, an association, a joint stock company, a trust, an unincorporated organization, a government, or a political subdivision of a government.
- **Definition:** "**Security**" (Cal. Corp. Code §25019) means any note; stock; treasury stock; membership in an incorporated or unincorporated association; bond; debenture;

evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral trust certificate; preorganization certificate or subscription; transferable share; **investment contract**; viatical settlement contract or a fractionalized or pooled interest therein; life settlement contract or a fractionalized or pooled interest therein; voting trust certificate; certificate of deposit for a security; interest in a limited liability company and any class or series of those interests (including any fractional or other interest in that interest), except a membership interest in a limited liability company in which

the person claiming this exception can prove that all of the members are actively engaged in the management of the limited liability company; provided that evidence that members vote or have the right to vote, or the right to information concerning the business and affairs of the limited liability company, or the right to participate in management, shall not establish, without more, that all members are actively engaged in the management of the limited liability company; certificate of interest or participation in an oil, gas or mining title or lease or in payments out of production under that title or lease;

put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof); or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency; any beneficial interest or other security issued in connection with a funded employees' pension, profit sharing, stock bonus, or similar benefit plan; or, in general, any interest or instrument commonly known as a “security”; or any certificate of interest or participation in, temporary or interim certificate for, receipt for,

guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing. All of the foregoing are securities whether or not evidenced by a written document.

- **Case Law:** California Courts apply two independent tests to determine if a transaction constitutes an "**Investment Contract**": (1) the 'risk capital test" and (2) the federal (Howey) test. If either is satisfied, the transaction is an investment contract.
  - Risk Capital Test: Silver Hills Country Club v. Sobieski, 55 Cal.2d 811, 814

California Law

(1961) Security is defined broadly "to protect the public against spurious schemes, however ingeniously devised, to attract risk capital." Therefore, a transaction can be a Security even if the transaction is not designed to obtain a material benefit. "Since the act does not make profit to the supplier of capital the test of what is a security, it seems all the more clear that its objective is to afford those who risk their capital at least a fair chance of realizing their objectives in legitimate ventures whether or not they expect a return

on their capital in one form or another." Id. at 815.

- Federal Test: SEC v. Howey Co. , 328 U.S. 293, 298-299 (1946) "[A]n investment contract, for purposes of the Securities Act, means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal

interest in the physical assets employed in the enterprise."

- The Howey Test is used at a Federal and State level to determine when a partnership or joint venture interest is a Security, and at a Federal level to determine when an LLC interest is a Security. (Consolidated Management Group, LLC v. Department of Corporations, 162 Cal. App.4th 598 (Court of Appeal, First District, Division 1, 2008) "A general partnership or joint venture interest can be designated a security if

the investor can establish, for example, that (1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he

cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers." (quoting Williamson v. Tucker 645 F.2d 404, 424 (5th Cir.1981)).

- **Exemption for Foreign Advisers** (Cal. Corp. Code §25202)**:** (a) An investment adviser shall not be subject to Section 25230 if (1) the investment adviser does not have a place of business in this state and (2) during the preceding 12-month period has had fewer than six clients who are residents of this state.
- **Exemption for Federally Registered Advisers** (Cal. Corp. Code §25230.1)**:** (a) A person that is

registered under Section 203 of the Investment Advisers Act of 1940 as an investment adviser is not subject to the requirement of obtaining a certificate under Section 25230, but may not conduct business in this state unless the person has fewer than six clients as specified in Section 25202 or unless the person first complies with subdivision (b) [Notice filing with the State, payment of fee, and compliance of investment adviser representatives with applicable qualifications]. An investment adviser representative that has a place of business in this state may be required to obtain a certificate pursuant to Section 25231.

- **Exemption for Private Fund Advisers** (10 CCR §260.204.9): (b) Exemption for **private fund advisers**. Subject to the additional requirements of subsection (c) of this rule below, a **private fund adviser** shall be exempt from the certificate requirement of Section 25230(a) of the Code if the **private fund adviser** satisfies each of the following conditions:

  (1) neither the **private fund adviser** nor any of its advisory affiliates are subject to federal or state bad actor disqualification; and

  (2) the **private fund adviser** files with the Commissioner:

(A) each report and amendment thereto that an **exempt reporting adviser** is required to file with the SEC pursuant to Rule 204-4; or

(B) if the **private fund adviser** is not required to submit such filings to the Securities and Exchange Commission, the **private fund adviser** prepares and files the reports and amendments referenced in paragraph (2)(A) immediately above (on or before the date(s) such reports would be required to be filed pursuant to Rule 204-4) directly with the Commissioner.

(3) The **private fund adviser** pays the required fees.

(c) Additional requirements for **private fund advisers** to certain **retail buyer funds**. In order to qualify for the exemption described in subsection (b) of this rule, a **private fund adviser** who advises at least one **retail buyer fund** shall, except as otherwise provided in subsection (h) of this rule, in addition to satisfying each of the conditions specified in subsections (b)(1) through (b)(3) of this rule, comply with each of the following requirements with respect to each **retail buyer fund** advised by the private fund adviser:

(1) The **private fund adviser** shall advise only **retail buyer funds** whose outstanding securities (other than short-term paper) are beneficially owned entirely by:

(A) persons who, at the time the securities were sold, were either accredited investors or were managers, directors, officers, or employees of the **private fund adviser**; or

(B) any person that obtains the securities through a transfer not involving a sale of that security.

(2) (A) At or before the time of purchase of any ownership interest in a **retail buyer fund**, the **private fund adviser** shall disclose:

(i) all services, if any, to be provided by the investment adviser to a beneficial owner of the fund, and to the fund itself; and

(ii) all duties, if any, the investment adviser owes to a beneficial owner of the fund, and to the fund itself.

(3) (A) The **private fund adviser** shall obtain annual audited financial statements of each **retail buyer fund** advised by the **private fund**

adviser, and shall deliver the same to each beneficial owner of the **retail buyer fund** within 120 days after the end of each fiscal year (or within 180 days if the **retail buyer fund** is a fund of funds);

(4) A **private fund adviser** cannot charge capital appreciation fees except to qualified clients.

(e) Investment adviser representatives. A person is exempt from the requirements of Section 25230(b) of the Code if he or she is employed by or associated with an investment adviser that is exempt from registration in this state pursuant to this rule and

does not otherwise act as an investment adviser representative.

- **Definition: "Private Fund Adviser"** means an investment adviser who provides advice solely to one or more **qualifying private fund(s)**.
- **Definition:** "**Qualifying Private Fund**" means an issuer that qualifies for the exclusion from the definition of an investment company under one or more of sections 3(c)(1), 3(c)(5), and 3(c)(7) of the Investment Company Act of 1940, as amended.
- **Definition: "Retail Buyer Fund"** means a **qualifying private fund** that is not a

venture capital company and that qualifies for the exclusion from the definition of an investment company under one or both of sections 3(c)(1) and 3(c)(5) of the Investment Company Act of 1940, as amended.

What Must a Registrant Do?

- **Qualification of Representatives and Associated Persons** (Cal. Corp. Code §25230): (b) No person, on behalf of an investment adviser that has obtained a certificate pursuant to Section 25231, may, in this state: offer or negotiate for the sale of investment advisory services of the investment adviser; determine which recommendations shall be made to, make recommendations to, or manage the accounts of, clients of the investment adviser . . . unless the investment adviser and that person have complied with

rules that the commissioner may adopt for the qualification and employment of those persons.

- **Regulations** (10 CCR §260.236)**:** References to an investment adviser representative shall mean both an investment adviser representative and an associated person of an investment adviser, as those terms are defined in Section 25009.5(a) and (b) of the Code.[1]

[1] (a) "Investment adviser representative" or "associated person of an investment adviser" means any partner, officer, director of (or a person occupying a similar status or performing similar functions) or other individual, except clerical or ministerial personnel, who is employed by or associated with, or subject to the supervision and control of, an investment adviser that has obtained a certificate or that is required to obtain a certificate under this law, and who does any of the following:

(1) Makes any recommendations or otherwise renders advice regarding securities.

(2) Manages accounts or portfolios of clients.

California Law

(a) Qualification Requirements. An investment adviser and each investment adviser representative shall pass, within two years prior to the date of filing the application for an investment adviser certificate or becoming engaged as an investment adviser representative:

(3) Determines which recommendation or advice regarding securities should be given.

(4) Solicits, offers, or negotiates for the sale or sells investment advisory services.

(5) Supervises employees who perform any of the foregoing.

(b) "Investment adviser representative" means, with respect to an investment adviser subject to Section 25230.1, a person defined as an investment adviser representative by Rule 203A-3 of the Securities and Exchange Commission (17 C.F.R. 275.203A-3) [a supervised person who has more than five clients who are natural persons and more than ten percent of whose clients are natural persons] and who has a place of business in this state.

(1) the Series 65/Uniform Investment Adviser Law Examination in effect on January 1, 2000 ("2000 Series 65 Examination"), or

(2) the Series 7/General Securities Representative Examination ("Series 7 Examination) and the Series 66/Uniform Combined State Law Examination ("2000 Series 66 Examination").

(b) Waivers: The requirements of subsection (a) do not apply to:

(1) Any investment adviser or individual employed or engaged as an

investment adviser representative registered, reported or licensed in any state of the United States as of December 31, 1999. . . .

(2) Any investment adviser or investment adviser representative who has been actively and continuously engaged in the securities business as a broker-dealer, an agent of a broker-dealer, an investment adviser, or an investment adviser representative without substantial interruption (two or more years) since passing the qualifying examination(s) and who has:

(A) passed the Series 2 Examination (SEC/FINRA Nonmember General Securities Examination) or passed the Series 7 Examination before January 1, 1998, or

(B) passed the Series 65 Examination or Series 66 Examination before January 1, 2000 and has passed the Series 7 Examination.

(c) Exemptions. Subsection (a) shall not apply to:

(1) any individual who has been registered as an investment adviser or employed or engaged as an investment adviser representative in any state for two consecutive years

immediately before the date of filing an application or notice pursuant to Corporations Code Section 25230(b) or 25230.1(c) in this state. This provision shall not apply to an individual using the exemption in subsection (c)(2).

(2) any investment adviser representative employed by or engaged by an investment adviser only to offer or negotiate for the sale of investment advisory services of the investment adviser.

(3) any individual who currently holds one of the following professional designations:

(A) Chartered Financial Analyst ("CFA") granted by the CFA Institute;

(B) Chartered Financial Consultant ("ChFC") awarded by The American College, Bryn Mawr, Pennsylvania;

(C) CERTIFIED FINANCIAL PLANNER™ or CFP® issued by the Certified Financial Planner Board of Standards, Inc.;

(D) Chartered Investment Counselor ("CIC") granted by the Investment Adviser Association; or

(E) Personal Financial Specialist ("PFS") administered by the American Institute of Certified Public Accounts.

(d) An individual who has not been registered in any state for a period of two years shall be required to comply with the examination requirements of this rule. This provision shall not apply to an individual using the exemption in subsection (c)(2) or (c)(3).

- **Limitations on Investment Advisory Contracts** (Cal. Corp. Code §25234)**:** (a) No investment adviser licensed under this chapter shall in this state enter into, extend or renew any investment advisory contract, or in any way perform any investment advisory contract entered into, extended or renewed on or after the effective date of this law, if that contract:

  (1) Provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client, except as may be permitted by rule or order of the commissioner

[certain exemptions apply, including for qualified clients];

(2) Fails to provide, in substance, that no assignment of the contract shall be made by the investment adviser without the consent of the other party to the contract;

(3) Fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of the partnership within a reasonable time after the change.

- **Antifraud Provisions** (Cal. Corp. Code §25235)**:** It is unlawful for any investment adviser, directly or indirectly, in this state:

  (a) To employ any device, scheme, or artifice to defraud any client or prospective client.

  (b) To engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any client or prospective client.

  (c) Acting as principal for his own account, knowingly to sell any security to or purchase any security from a client for whom he is acting as investment adviser, or, acting as broker for a person other

than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of the transaction the capacity in which he is acting and obtaining the written consent of the client to such transaction.

(d) To engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The commissioner shall, for the purpose of this subdivision, by rule define and prescribe means reasonably designed to prevent such acts, practices, and courses of

business as are fraudulent, deceptive, or manipulative.

(e) To represent that he is an investment counsel or to use the name "investment counsel" as descriptive of his business unless his principal business consists of acting as investment adviser and a substantial part of his business consists of rendering investment advisory services on the basis of the individual needs of his clients.

- **Regulation** (10 CCR §260.235.4): (a) It shall constitute a fraudulent, deceptive, or manipulative act, practice or course of business

within the meaning of Section 25235 of the Code for any investment adviser to fail to disclose to any client or prospective client all material facts with respect to:

(1) A financial condition of the adviser that is reasonably likely to impair the ability of the adviser to meet contractual commitments to clients if (A) the adviser has discretionary authority (express or implied) or custody over such client's funds or securities, or (B) requires prepayment of advisory fees from such client 6 months or more in advance; or

(2) A legal or disciplinary event that is material to an evaluation of the adviser's integrity or ability to meet contractual commitments to clients.

- **Regulation—Custody Requirements** (10 CCR §260.237).

- **Minimum Capital and Fidelity Bond** (Cal. Corp. Code §25237).
- **Fair, Equitable and Ethical Principles** (Cal. Corp. Code §25238)**:** No investment adviser licensed under this chapter and no natural person associated with the investment adviser shall engage in

investment advisory activities, or attempt to engage in investment advisory activities, in this state in contradiction of such rules as the commissioner may prescribe designed to promote fair, equitable and ethical principles.

- **Regulation** (10 CCR §260.238)**:** The following activities do not promote "fair, equitable or ethical principles," as that phrase is used in Section 25238 of the Code:

  (a) Recommending to a client to whom investment supervisory, management or consulting services are provided the purchase, sale or

exchange of any security without reasonable grounds to believe that the recommendation is suitable for the client on the basis of information furnished by the client after reasonable inquiry concerning the client's investment objectives, financial situation and needs, and any other information known or acquired by the adviser after reasonable examination of such of the client's records as may be provided to the adviser.

(h) Misrepresenting to any advisory client, or any prospective advisory client, the qualifications of the adviser, its representatives or

any employees, or misrepresenting the nature of the advisory services being offered or fees to be charged for such service, or omitting to state a material fact necessary to make the statements made regarding the qualifications, services or fees, in light of the circumstances under which they are made, not misleading.

(j) Charging a client an advisory fee that is unreasonable in light of the type of services to be provided, the experience and expertise of the adviser, the sophistication and bargaining power of the client, and whether the

adviser has disclosed that lower fees for comparable services may be available from other sources.

(k) Failing to disclose to a client in writing before entering into or renewing an advisory agreement with that client any material conflict of interest relating to the adviser, its representatives or any of its employees, which could be reasonably expected to impair the rendering of unbiased and objective advice including:

(1) Compensation arrangements connected with advisory services to clients which

are in addition to compensation from such clients for such services; and

(2) Charging a client an advisory fee for rendering advice without disclosing that a commission for executing securities transactions pursuant to such advice will be received by the adviser, its representatives or its employees, or that such advisory fee is being reduced by the amount of the commission earned by the adviser, its representatives or employees for the sale of securities to the client.

(n) Entering into, extending or renewing any investment advisory contract, other than a contract for impersonal advisory services, unless such contract is in writing and discloses, in substance, the services to be provided, the term of the contract, the advisory fee or the formula for computing the fee the amount or the manner of calculation of the amount of the prepaid fee to be returned in the event of contract termination or nonperformance, whether the contract grants discretionary power to the adviser or its representatives.

(o) Making any untrue statement of a material fact or omitting a statement of material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading in the solicitation of advisory clients.

- **Maintenance of Books and Records** (Cal. Corp. Code §25241): (c) All records referred to in this section are subject at any time and from time to time to reasonable periodic, special, or other examinations by the commissioner, within or without this state, as the commissioner deems necessary or appropriate in the

public interest or for the protection of investors.

- **Regulation** (10 CCR §260.241.3): Books and Records to Be Maintained by Investment Advisers.

- **Remedies for Violation—Administrative Penalties** (Cal. Corp. Code §25252): fines and cease and desist order.
- **Remedies for Violations—Criminal Proceedings** (Cal. Corp. Code §25533)**:** referral to the Attorney General or the district attorney of the county in which the violation occurred, for criminal proceedings.
- **Remedies for Violations—Civil Penalties** (Cal. Corp. Code §25535)**:** civil penalties not to exceed twenty-five

thousand dollars ($25,000) for each violation.

- **Remedies for Violations—Punishment** (Cal. Corp. Code §25540)**:** any person who willfully violates any provision of this division, or who willfully violates any rule or order under this division, shall upon conviction be fined not more than one million dollars ($1,000,000), or imprisoned pursuant to subdivision (h) of Section 1170 of the Penal Code, or in a county jail for not more than one year, or be punished by both that fine and imprisonment; but no person may be imprisoned for the violation of any rule or order if he or she proves

that he or she had no knowledge of the rule or order.

Federal Law

- **Operative Provision**—Registration of investment advisers. (15 U.S.C. §80b-3). (a) Necessity of registration. Except as provided in subsection (b) and section 80b-3a of this title [state regulated investment advisers, see below], it shall be unlawful for any investment adviser, unless registered under this section, to make use of the mails or any means or instrumentality of interstate commerce in connection with his or its business as an investment adviser.

(b) Investment advisers who need not be registered. The provisions of subsection (a) shall not apply to--

(1) any investment adviser, other than an investment adviser who acts as an investment adviser to any **private fund**, all of whose clients are residents of the State within which such investment adviser maintains his or its principal office and place of business. . .

(m) Exemption of and reporting by certain private fund advisers.

(1) In general. The Commission shall provide an exemption from the registration requirements under this section to any investment adviser

of **private funds**, if each of [sic] such investment adviser acts solely as an adviser to **private funds** and has assets under management in the United States of less than $150,000,000.

(2) Reporting. The Commission shall require investment advisers exempted by reason of this subsection to maintain such records and provide to the Commission such annual or other reports as the Commission determines necessary or appropriate in the public interest or for the protection of investors.;

- **Definition**: "**Private Fund**" (15 U.S.C. §80b-2(a)(29)) means "an issuer that

would be an investment company, as defined in section 3 of the Investment Company Act of 1940, but for section 3(c)(1) [less than 100 holders] or 3(c)(7) [qualified purchasers] of that Act."

- **Regulation** (17 C.F.R. § 275.203(m)-1) (a) United States investment advisers. For purposes of section 203(m) of the Act (15 U.S.C. 80b–3(m)), an investment adviser with its principal office and place of business in the United States is exempt from the requirement to register under section 203 of the Act if the investment adviser:

Federal Law

(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.

- **Definition**: "**Private Fund Assets**" means the investment adviser's **assets under management** attributable to a **qualifying private fund**.
- **Definition: "Qualifying Private Fund"** means any **private fund** that is not registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8) and

has not elected to be treated as a business development company pursuant to section 54 of that Act (15 U.S.C. 80a–53). For purposes of this section, an investment adviser may treat as a **private fund** an issuer that qualifies for an exclusion from the definition of an "investment company," as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. 80a–3), in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a–3(c)(1) or 15 U.S.C. 80a–3(c)(7)), provided that the investment adviser treats the

issuer as a private fund under the Act (15 U.S.C. 80b) and the rules thereunder for all purposes. [Note: this means 3(c)(5) issuers can by Qualifying Private Funds.]

- Exempt Reporting Advisers (which includes investment advisers relying on 15 U.S.C. § 80b-3(m)) must file Form ADV (17 C.F.R. § 275.204-4)

- **Operative Provision**—State and Federal Responsibilities (15 U.S.C. §80b-3a).
  - Advisers whose principal office and place of business are in California with

Assets Under Management of less than $25 million cannot elect Federal regulation unless they are an adviser to a registered investment company or a business development company.

- Advisers whose principal office and place of business are in California with **Assets Under Management** between $25 million and $100 million cannot elect Federal regulation unless
  - They are an adviser to a registered investment company or a business development company; or

- They would be required to register with 15 or more States.

- Advisers whose principal office and place of business are in California with **Assets Under Management** above $100 million are subject to Federal regulation.

- **Definition: "Assets Under Management"** (15 U.S.C. §80b-3a(a)(3)) means "the **securities portfolios** with respect to which an investment adviser provides continuous and regular supervisory or management services."

Federal Law

- **Definition**: "**Securities Portfolio**" (Instruction 5.b for Part 1A of Form ADV). "An account is a securities portfolio if at least 50% of the total value of the account consists of **securities**". However, all of the assets of a **Private Fund** are treated as a securities portfolio regardless of the nature of such assets, including any uncalled commitments.
- **Definition**: "**Security**" (15 U.S.C. §80b-2(a)(18)) means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing

agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, **investment contract**, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument

commonly known as a “security”, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing.

- Note: this definition is similar to, but not identical with, the California definition of Security. For example, it does not reference membership interests in LLCs.

Similarities Between Federal and State Regulation

- Application for Registration is made on Form ADV (Part I and Part II) via IARD.
- Both types of registrants must maintain specified books and records.
- Both types of registrants are subject to books and records exams.
- Both types of registrants are subject to restrictions on advertisements.
- Both types of registrants are prohibited from engaging in principal transactions.

Comparison of Federal and California Law

- Both types of registrants are prohibited from earning a fee on capital gains or capital appreciation except for qualified clients.
- Both types of registrants are subject to custodial requirements.

Differences Between Federal and State Registration

- Investment adviser representatives and associated persons of California registrants are required to pass the Series 65 or Series 7 exam (subject to certain exceptions).
- California registrants are subject to regulations regarding fair, equitable and ethical principles.
- Federal registrants must adopt a Code of Ethics (17 C.F.R. §275.204A-1), which, among other things, requires access persons to provide holdings reports and transaction reports for securities transactions.

Comparison of Federal and California Law

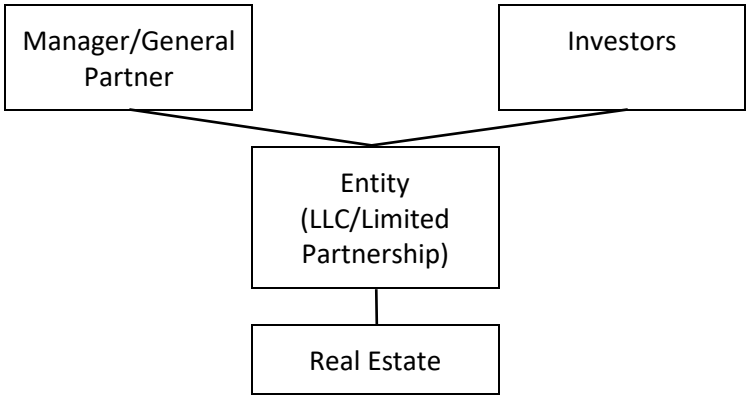
- Federal registrants much adopt and implement written policies and procedures reasonably designed to prevent violations by it and its supervised persons, of the Act, must review their policies and procedures at least annually, and must designate a chief compliance officer (17 C.F.R. §275.206(4)-7).
- Federal registrants have specific regulations regarding the use of solicitors (17 C.F.R. § 275.206(4)-3).
- Federal registrants have specific regulations regarding political contributions to combat “pay for play” (17 C.F.R. § 275.206(4)-5).

Comparison of Federal and California Law

- Applies to Exempt Reporting Advisers as well.

Investment Scenarios

Scenario 1–Internally Managed Investment:

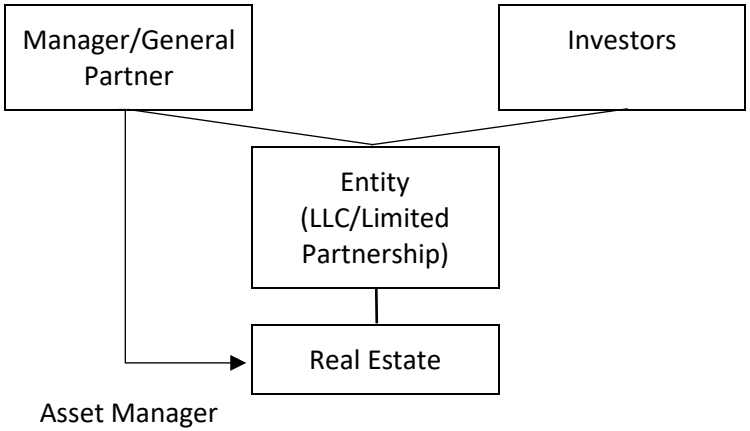


- Investors' interest in Entity is a Security—Investors are investing money in a "common enterprise" and are expecting "profits solely from the efforts of the" Manager/General Partner. (Howey).

Common Pitfalls

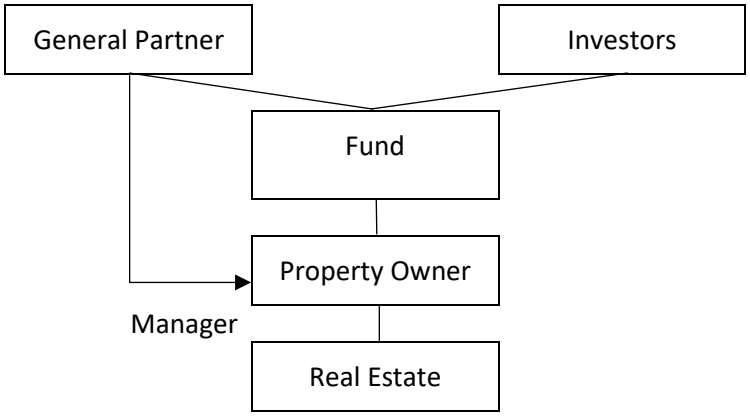
- But the Entity is relying only on its own efforts to realize profits from the Entity's investment in the Real Estate. The Entity's investment in Real Estate is therefore not a Security.

Scenario 2–Externally Managed Real Estate:



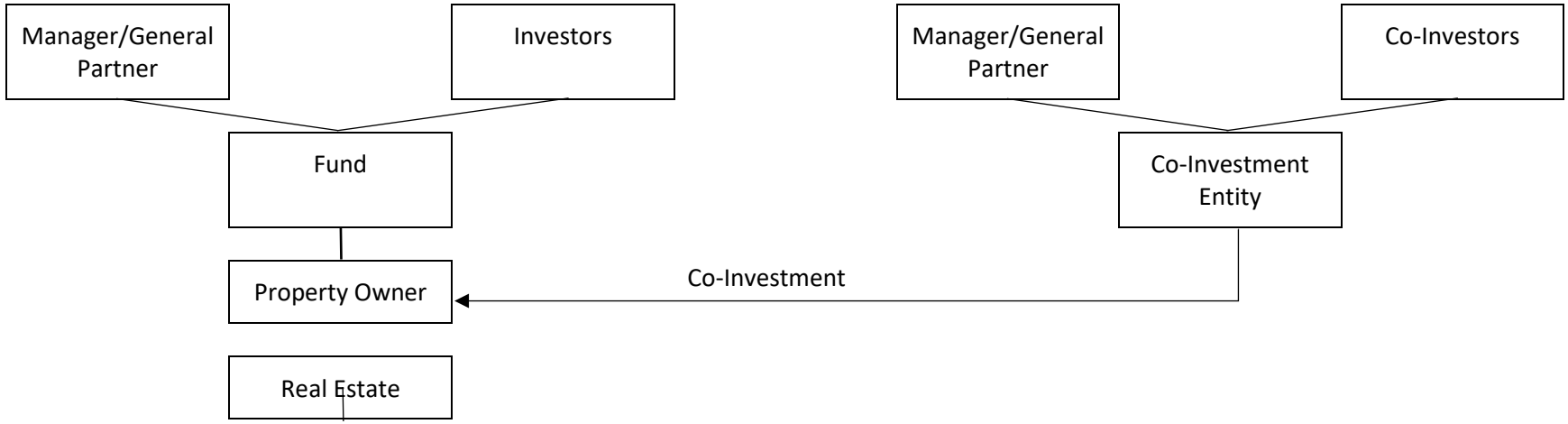
- Unlike Scenario 1, in this case Entity is relying on the efforts of a third party, the Manager/General Partner, to realize profits from its investment in the Real Estate. The Entity's interest in the Real Estate is therefore a Security.

Scenario 3–Externally Managed Investment:



- This is similar to Scenario 2 in that the Fund is relying on the efforts of a third party, the General Partner, to realize its profits from its investment in Property Owner. The Fund's interest in Property Owner is thus a Security.

Scenario 4–Co-investment:



- While the scenario is the same as Scenario 1 for the Investors, the same analysis must also be done for the Co-Investors. Unless they have equal management rights in Property Owner, the Co-Investment Entity's investment in Property Owner is a Security.

Practical Consequences of Registration

- For Federal Registration:
  - Must filed Form ADV.
  - Must appoint a Chief Compliance Officer.
  - Must promulgated and implement policies and procedures and a Code of Ethics.
    - Must monitor access persons' security transactions for violations of securities laws.
    - Must monitor political contributions.
  - Must maintain books and records.

Practical Consequence of Registration

- Advisory contracts must satisfy statutory requirements.
- Must satisfy custodial requirements.
- Must have annual reviews of compliance program.

- For State Registration:
  - Must file Form ADV.
  - Investment adviser representatives and associated persons must be qualified.
  - Advisory contracts must satisfy statutory requirements.
  - Must maintain books and records.

Practical Consequence of Registration

- Must satisfy custodial requirements.

- Don't fear registration:
  - Registration is a symbol of success. You are playing in the big leagues.
  - Many institutional investors will not invest with non-registered advisers.
- Embrace compliance and integrate compliance into your business:
  - Compliance failures can have direct (financial) and indirect (reputational) consequences.

Practical Consequence of Registration

- Good compliance is part of good business.