inside

New Rules

When do investment advisers need to register with the state?

Page 22

Tough Stand

The 5th Circuit's position on material misstatements by a company.

Page 24

SEC in Transition

Key enforcement issues affecting public companies.

Page 26

Special Report

Securities Litigation & Corporate Governance

Rules for Investment Advisers

Changes to the Texas Registration Exemption

by CLIFF ERNST

Lawyers who advise private investment entities need to be aware of changes to Texas regulations governing when investment advisers need to register with the state. That's because, after 16 months of debate, the Texas State Securities Board recently amended the Texas Security Act's implementing regulations to modify the exemption from state registration for investment advisers. The board passed the new amendments on June 10 and published them in the *Texas Register* on July 8.

The amendments impact Texas counsel to private investment entities, such as venture-capital, private equity and real estate limited partnerships. Lawyers must pay particular attention to liquidity events and redemption triggers that apply to natural persons in those investment entities, especially when the real people go through events such as death or divorce. A slip up in this area could trigger the application of Texas law requiring general partners and other investment advisers to the entity to register as investment advisers.

U.S. and Texas laws require people who engage in the business of advising others about the value of securities or the advisability of purchasing or selling securities for compensation to register as an investment adviser (IA). The Investment Advisers Act of 1940 (IAA) establishes this registration requirement at the federal level, while the Texas registration requirement is found in §12.B of the Texas Securities Act.

Various exemptions from IA registration apply at federal and state levels. For example, at the federal level, an IA is generally exempt from registering under the IAA where, among other things, he advises fewer than 15 clients and he neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any registered investment company. At the state level, old §109.3 of the Texas Securities Act's implementing regulations (the Texas regulations) provided an exemption from state registration for, among other things, an IA to certain "accredited

investors" as federally defined under Regulation D, which includes entities composed of high-net-worth natural persons. Consequently, the general or managing partner (GP) of a Texas-based investment partnership was generally not required to register as an IA at the federal level (assuming the GP advised 14 or fewer funds) or at the state level (assuming all of the investors or limited partners in the fund met the standards laid out under Regulation D for accredited investors).

Practitioners generally believed that old §109.3 exempted the GPs of investment partnerships composed of accredited natural persons from IA registration under the Texas Securities Act. However, in recent years the State Securities Board of Texas' general counsel indicated, in interpretive letters and comments to the press, that the board did not view a limited partnership or other investment entity composed of accredited natural persons as qualifying for the Texas exemption. This created confusion among practitioners as to the authority for the board's position and whether the GP to an investment partnership composed of accredited natural persons was required to register as an IA under the Texas Securities Act.

Against that backdrop, the board first proposed amending §109.3 in February 2004 to eliminate the exemption from Texas registration for an IA to any investment entity containing natural persons, accredited or otherwise. After some debate, in August 2004 the board withdrew its February 2004 proposal and proposed in its place a new §109.6 governing investment advisers. Proposed §109.6 continued to exclude natural persons and any entity composed of natural persons from the exemption's accredited investor standard. This continued to alarm Texas fund managers and practitioners, and in March 2005, the board replaced the August 2004 proposal, which had expired, with a new proposal that recast the amendment for the third time in a slightly different manner.

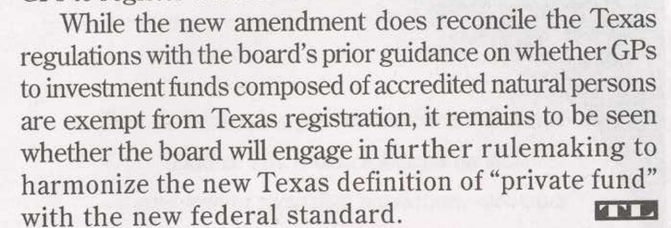
The version of §109.6 published in March 2005 removed the exclusion of natural persons from the exemption's accredited investor standard but added new language stating that the Texas exemption would not be available for any IA to a natural person or to a private fund. The term "private fund" was defined in a three-prong test as a company that: 1. would be an investment company under the federal Investment Company Act of 1940 but for certain exceptions therein; 2. allows its owners to redeem their interests within two years of investment; and 3. has sold ownership interests based upon the investment advisory skills, ability or expertise of the investment advisers. This definition is similar, but not identical, to the "private fund" definition recently promulgated by the U.S. Securities and Exchange Commission in its effort to regulate hedge fund managers. Importantly, and in contrast to the newly adopted Texas definition discussed below, the new federal definition of "private fund" includes an exception if the fund allows redemption of interests upon extraordinary circumstances, such as the death or insolvency of the GP, that are customary in fund formation documents.

Practitioners should be careful to carve out natural persons from the general redemption or liquidity triggers that may apply to institutional investors within two years of purchase.

The Final Rule

Section 109.6 as finally adopted substantially resembles the March 2005 proposal but includes several changes responsive to comment letters. Most notably, the board changed the second prong of the three-prong "private fund" definition, the liquidity prong. As adopted, this prohibition on short-term redemptions only applies to natural persons.

Since most investment partnerships will meet the first and third prongs of the "private fund" definition, funds must be structured to avoid tripping over the second or "liquidity" prong and thus being classified as a "private fund." Practitioners should be careful to carve out natural persons from the general redemption or liquidity triggers that may apply to institutional investors within two years of purchase. They should take particular care regarding certain redemption triggers that are uniquely applicable to natural persons (*e.g.*, death or divorce) and that sometimes appear in entity formation documents. Otherwise, the entity risks classification as a "private fund" that would require the GPs to register with the board.



While the new amendment does reconcile the Texas regulations with the board's prior guidance on whether GPs to investment funds composed of accredited natural persons are exempt from Texas registration, it remains to be seen whether the board will engage in further rulemaking to harmonize the new Texas definition of "private fund" with the new federal standard. TL

Cliff Ernst is a shareholder and head of the corporate section in Austin's Graves, Dougherty, Hearon & Moody. He has more than two decades of experience in corporate and business law. His practice encompasses mergers and acquisitions, equity offerings, venture capital and debt financings, general contracting, and general corporate counseling. His e-mail address is cernst@gdhm.com.