



# Practice Pointer

## Michigan's Securities Regulator Issues New Rules, Including a New Private Fund Adviser Registration Exemption

### Securities Law Committee

### Federal Bar Association Eastern District of Michigan Chapter

The Securities Committee for the Eastern District of Michigan Chapter of the FBA focuses on Federal and Michigan securities laws and issues. The Committee offers perspectives of in-house corporate counsel as well as members of the securities plaintiffs and defense bars.

The Securities Committee handles and examines regulatory, litigation, arbitration, and criminal law enforcement issues facing public and private companies operating in today's global commercial and securities markets, as well as the officers and directors of those companies and the professionals (lawyers, accountants, auditors, and investment advisers) advising them.

In addition, the Committee has experience with issues facing investment advisers, broker-dealers, and private funds.

### Securities Law Committee Co-Chairs

Matt Allen  
Miller Canfield  
[allen@millercanfield.com](mailto:allen@millercanfield.com)

E. Powell Miller  
The Miller Law Firm  
[epm@millerlawpc.com](mailto:epm@millerlawpc.com)

In House Liaison: David  
Witten, Ford Motor Company

The Corporations, Securities, & Commercial Licensing Bureau of the Michigan Department of Licensing and Regulatory Affairs ("the Bureau") has issued new Securities Rules interpreting and enforcing the Michigan Uniform Securities Act ("the Michigan Securities Act"). The Securities Rules are found in the Michigan Administrative Code and apply to all persons subject to Michigan Securities Act. See Mich Admin Code R 451.2102(a).

The Securities Rules and the Michigan Securities Act incorporate certain key rules and definitions from the U.S. Securities Exchange Commission ("SEC") Rules and the federal securities laws, including the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Securities Act of 1933, and the Securities Exchange of 1934 ("federal securities laws").

Businesses, advisers, and funds registered with the SEC or governed by the federal securities laws are still affected by the Michigan Securities Act and the Michigan Securities Rules as it pertains to their individual investment advisers and registered representatives operating in Michigan, and private funds and private fund investors residing in Michigan. The Securities Rules affect transactional practitioners advising the creation or operation of a securities fund or adviser, and litigators responding to a law enforcement or regulatory inquiry.

One of the most significant changes to the Securities Rules is the addition of a private fund adviser exemption. This Rule took effect on January 3, 2020. Investment advisers advising hedge funds and other private funds and their investors in Michigan may be exempt from registering with the Bureau.

Registration exemption provides some privacy and reduced regulatory costs to certain private funds and advisers to those funds that qualify. To qualify, the fund or funds being advised must have investors that have investment experience and assets sufficient to weather the potential heightened risk attendant to private fund investing with advisers that are exempt from registration.

Below is an analytical outline of the relevant Michigan securities laws and rules pertaining to a private fund adviser registration exemption under Securities Rule 4.5. See Mich. Admin. Code R 451.4.5. This analysis presumes the private fund adviser is precluded from registering with the SEC as a federal covered adviser, and must register with the State of Michigan or be eligible for a registration exemption under the Michigan Securities Rules.

### Michigan Investment Adviser Registration Requirements under the Michigan Securities Act

- An investment adviser does not have to register with the State of Michigan if it is "exempted by rule or order under [Michigan Securities Act]." See MCL 451.2403(2)(e) (Section 403(2) of the Michigan Securities Act).
- An investment adviser representative does not have to register with the State of Michigan if he is "employed by or associated with" an investment adviser that is exempt from registration under Section 403(2). See MCL 451.2403(4).



## **The Michigan Securities Rules**

- Part 4 of the Michigan Securities Rules, revised and effective July 3, 2019, exempts from registration investment advisers to private funds, Mich Rule 4.5. *See Mich Admin Code R 451.4.5.*
- Mich Rule 4.5 is the only Rule that took effect on the later date of January 3, 2020. *See Mich. Rule 4.5(1).*
- Some preliminary definitions are required to interpret Mich Rule 4.5.

### **Michigan Securities Rule 1.1: Definitions Relevant to the Private Fund Adviser Exemption**


- "3(c)(1) fund" is a "qualifying investment fund" that is excluded from the definition of investment company under Section 3(c)(1) of the Investment Company Act of 1940, 15 USC 80a-3(c)(1). *See Mich Rule 1.1(a).*
- "Private fund adviser" is an investment adviser who provides advice to one or more "qualifying private funds." *See Mich Rule 1.1(x).*
- "Qualifying private fund" is a private fund that meets the definition of "qualifying private fund" in SEC Rule 203(m)-1. *See Mich Rule 1.1(y).*
  - SEC Rule 203(m)-1 defines "qualifying private fund" as a fund exempt from the definition of "investment company" under the Investment Company Act of 1940, including Sections 3(c)(1) or 3(c)(7) of that act, 15 USC 80a-3(c)(1), (7). *See 17 CFR 275.203(m)-1(d)(5).*
    - Section 3(c)(1) exempts from the definition of investment company any issuer:
      - Whose securities are not owned by more than 100 persons, and
      - Which does not make or plan to make a public offering of securities
    - Section 3(c)(7) exempts from the definition of investment company any issuer:
      - Whose private securities are owned "exclusively" by "qualified purchasers."
      - "Qualified purchaser" means:
        - a. A natural person who owns not less than \$5 million in investments
        - b. A company that owns not less than \$5 million in investments and is owned directly or indirectly by 2 or more natural persons that are related
        - c. A trust not formed to acquire the offered securities, and the trustee and each settlor meet the requirements of subsections (i), (ii), or (iv)
        - d. A person who acts for his own account and accounts of other qualified purchasers on a discretionary basis who in the aggregate own not less than \$25 million in investments [*See 15 USC 80a-2(a)(51)(A)*]

### **Michigan Securities Rule 4.5: Registration Exemption for Investment Advisers**

Because most advisers will likely seek exemption for "3(c)(1) Funds," as defined in the Securities Rules, the analysis below will outline the registration exemption analysis for advisers to a "3(c)(1) Fund" that is not a "venture capital fund" as defined by the Michigan Securities and SEC Rules. An analysis for a venture capital fund registration exemption will be slightly different.

- A "private fund adviser" that advises at least one "3(c)(1) Fund" must meet five elements, with some exceptions noted below, to qualify for a Michigan registration exemption:
  1. Neither the private fund adviser nor its affiliates have been disqualified under SEC Regulation D.
  2. The private fund adviser files a Form ADV for exempt advisers pursuant to SEC Rule 204-4, 17 CFR 275.204-4, with the Investment Adviser Registration Depository (IARD)
  3. The private fund adviser advises private funds that are beneficially owned entirely by "qualified clients" as defined in SEC Rule 205-3, 17 CFR 275.205-3, or "accredited investors" as defined in SEC Rule 501, 17 CFR 230.501, at the time the securities are purchased from the issuing fund.
    - i. A "qualified client" under SEC Rule 205-3 is any one of the following:
      - a. A natural person or company that has at least \$1 million under management with the investment adviser, or
      - b. A natural person or company that the investment adviser reasonably believes either:
        - i. Has a defined "net worth" of more than \$2 million, or
        - ii. Is a "qualified purchaser" under Section 2(a)(51)(A) of the Investment Company Act, 15 USC 80a-2(a)(51)(A), or
      - c. A natural person who is an officer, director, employee, general partner, or serves in a similar capacity, of the investment adviser.




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- ii. An "accredited investor" under SEC Rule 501 includes, among other defined categories, any one of the following:
    - a. A director, officer, or general partner of the fund issuing the securities or any officer or general partner of a general partner of that issuer.
    - b. A natural person whose individual defined "net worth" or combined net worth with a spouse exceeds \$1 million.
    - c. A natural person with an individual annual income of \$200,000 or a combined income with spouse of over \$300,000
    - d. Any entity in which all of the equity owners are accredited investors
  - 4. At the time of purchase, the private fund adviser discloses the following to each beneficial owner of the private fund:
    - 1. All services to be provided to the owners
    - 2. All duties, if any, the investment adviser owes to the owners
    - 3. Any other material information
  - 5. The private fund adviser shall obtain annual audited financial statements for each 3(c)(1) fund and deliver a copy of the financial statements to each fund owner.

### **Exception to Element #3**

- If a 3(c)(1) fund has one or more beneficial owners who are not "qualified clients" or "accredited investors," it may still qualify for a private adviser registration exemption if all of the following conditions are met:
  - 1. The fund existed prior to the effective date of this regulation, which is January 3, 2020.
  - 2. As of the effective date of Mich Rule 4.5, the fund ceases to accept beneficial owners who are not "qualified clients" or "accredited investors."
  - 3. The investment adviser discloses in writing to each beneficial owner of the fund the information described in Element #2, namely the information contained in the Form ADV for exempt private advisers. The Form ADV need not be filed, only the information contained it must be sent in some written form to each beneficial owner.
  - 4. As of the effective date of Rule 4.5, the investment adviser delivers to each beneficial owner the financial statements described in Element #5, *unless* the investment adviser meets the Exception to Element #5.

### **Exception to Element #5**

- The private fund adviser does not have to create and deliver annual audited financial statements to each beneficial owner if both of the following conditions are met:
  - 1. Each beneficial owner is a "qualified client," and
  - 2. The private fund adviser provides to each beneficial owner a written disclosure explaining that the fund will not provide audited financial statements to owners annually, and that similarly situated funds may provide audited financial statements to their investors.



On behalf of the Securities Law Committee of the Federal Bar Association Eastern District of Michigan Chapter, we are pleased to provide this update on recent developments in securities law and regulation. We encourage your feedback as we plan to continue providing periodic updates that inform you of relevant happenings and updates in Michigan and federal securities law. Thanks for reading.

*About the Author: Matthew P. Allen is a litigator and trial lawyer with the Miller Canfield firm, who has tried and arbitrated a wide variety of cases in a wide variety of venues, from tough cases in the trenches of Detroit's criminal courts to sophisticated multimillion-dollar international intellectual property and securities cases. He also is a skilled appellate lawyer who has handled a variety of cases in state and federal appellate courts.*