INSIGHTS
The Corporate & Securities Law Advisor

VOLUME 33, NUMBER 3, MARCH 2019

SECURITIES REGULATION

Securities Law Considerations for Sponsors of Qualified Opportunity Zone Funds

The Tax Cuts and Jobs Act creates an incentive for taxpayers to make investments in qualified opportunity zones through qualified opportunity funds. Many tax credit fund managers are seeking to expand into these types of funds, but they may not have prior experience with a number of securities law regimes.

By Daniel L. McAvoy

The Tax Cuts and Jobs Act,[1] enacted in December 2017, included a number of incentives for taxpayers to make investments that might spur economic development and job growth. One of the key incentives involves qualified opportunity funds (or O-funds) that make investments in qualified opportunity zones (also known as O-zones or QOZs). If a taxpayer sells assets generating a capital gain, and invests the amount of the gain in an O-fund that complies with the relevant tax rules, then the taxpayer can defer and often reduce taxes on that gain, as well as not be taxable on a subsequent sale of the O-fund investment provided it is held for at least 10 years. O-zones were finalized in 2018, and along with a few designated adjacent tracts, they represent 25 percent of the low-income census tracts (with a minimum of 100) in each jurisdiction.

Many institutional managers see the opportunity zone program as a way to break into new markets or expand their existing investor base. In particular, many tax credit fund managers are seeking to expand into O-zone investing, taking advantage of their long history of investing in properties in locations that are now opportunity zones, as well as their extensive experience complying with specialized tax laws designed to encourage private sector development of low-income communities. That said, while traditional real estate fund managers generally will have experience with investment advisory and similar regimes but not with stringent tax compliance, managers of other tax-advantaged funds such as low-income housing tax credits (LIHTC), new markets tax credits (NMTC) and historic rehabilitation tax credit (HTC) funds may not have prior experience with a number of securities law regimes.

Are Lower-Tier Partnership Interests Securities?

Under the Securities Act of 1933 (Securities Act), the definition of "security" mostly includes a

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list of items that people generally think of as securities—stock, bonds, debentures, notes, securities futures and the like. Notably absent from this list are limited partnership interests and limited liability company interests. Instead, the definition includes the intentionally ambiguous "investment contract." When interests in partnerships and limited liability companies are investment contracts, those interests become securities that are subject to a full array of federal and state securities laws.

The seminal case interpreting what constitutes an investment contract is *S.E.C. v. W.J. Howey Co.*,[2] where the Supreme Court determined that an investment in an orange grove was actually an investment in a security due to the characteristics of the sale contract. The three original requirements for establishing an investment contract pursuant to what has become known as "the *Howey* Test" were (1) an investment of money, (2) in a common enterprise, (3) with profits solely due to the efforts of others. Over time, there have been numerous other cases determining the boundaries of when these various conditions are met. Some of these cases have tweaked the prongs of the *Howey* test themselves, such as a relaxation of the "solely" requirement,[3] or requiring only the expectation of profits rather than actual profits.[4] Some of these cases also have established circumstances where a limited partnership interest or limited liability company interest is not an investment contract.

While limited partnership interests in tax credit funds clearly are securities, the underlying investments (in housing or other projects) made by those funds typically are structured so that they are unlikely to be securities. A property interest in real estate is not a security,[5] but since that real estate typically is held through an LLC or limited partnership, the analysis as to whether the interest is a security is highly fact-specific. The term, "investment contract," as used in the Securities Act, does not specifically encompass partnership interests or limited liability company interests in the definition of a "security."[6] However, federal courts have reasoned that in determining whether an investment is a security, the form of the investment "should be disregarded for substance and the emphasis should be on economic reality." [7] Indeed, from its inception, the *Howey* Test was intended as a

> flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.[8]

With respect to lower-tier partnerships, the first two prongs of the *Howey* Test likely are to be satisfied, since there is an investment of money through the fund's purchase of the limited partnership or LLC interest, and there will almost always be a common enterprise because it is easier to meet the requisite ratios if ownership is through an entity that is not disregarded for tax purposes, and thus there must be more than one partner or member. Whether a limited partnership or LLC interest satisfies the third element of the *Howey* Test, however, is highly dependent on the facts of each case, requiring focus on the nature of the relationship between the parties and the contractual terms of the venture.[9] Because of the factual nature of the analysis, the federal courts have held that most, but not all, limited partner interests are securities.

Whether a limited partnership or LLC interest satisfies the third element of the Howey *Test is highly dependent on the facts of each case.*

Many courts have applied the *Howey* Test broadly to conclude that a limited partner interest constitutes an investment contract and, therefore, a security for purposes of federal securities laws.[10] When a limited partner relies on the general partner to manage the day-to-day operations of the partnership, the limited partner interest may be sufficiently

passive in nature so that it is an investment contract under the *Howey* Test.[11] As the court in *Mayer v. Oil Field Systems Corp.* stated, "[w]here the investing limited partners exercised no managerial role in the partnership's affairs, courts have held that limited partnership interests are securities."[12] Indeed, many traditional (non-tax credit) real estate funds, other than those that invest directly in the real estate itself, such as "equity REITs," consider themselves to be funds investing in securities.

By contrast, a number of cases have found that limited partner interests are *not* investment contracts where, among other things, the limited partner retained significant control over its investment under the partnership agreement and had significant negotiating leverage with few or no other third-party investors. The relevant analysis used in these cases generally turned on whether investors assumed "control over the significant decisions of the enterprise."[13] Courts have found that a limited partner interest is not an investment contract where the limited partner was sophisticated about the type of investment such that it could adequately protect its interests,[14] there was only one limited partner (or a small number of limited partners), there was no public offering, the negotiation of the partnership agreement was a one-on-one negotiation between the limited partner and general partner[15] and the limited partner retained control over its investment through the partnership agreement.[16] That said, limited partnership interests and LLC membership interests generally should be presumed to be securities, since they usually involve passive investors who rely on the general partner or manager to produce profits.

Limited partnership interests and LLC membership interests generally should be presumed to be securities.

Due to the strict requirements in order to produce tax credits, as well as the often limited expectation of profit from investing in lower-tier partnerships, the lower-tier investments of tax credit funds frequently are not securities. In contrast, O-fund managers may not be able to structure their investments in a manner that prevents them from being characterized as securities. The opportunity zone law itself encourages some decisions that increase the chances that an O-fund's investments will be securities. For example, if an O-Fund owns its projects directly, then 90 percent of all of its assets must be qualified opportunity zone business property. On the other hand, if the project is held by a subsidiary entity, *all* of that subsidiary entity's assets count toward the 90 percent threshold so long as at least 70 percent of that subsidiary's tangible assets are qualified opportunity zone business property and certain other conditions and limitations are adhered to. Furthermore, there presently are unanswered questions in the opportunity zone regulations—such as determining what constitutes an "active trade or business" or how staged exits ultimately can be effected in multi-property funds—that create uncertainty about how the opportunity zone fund properties will need to be managed and how the investments in those properties will need to be structured.

Are You an Investment Company?

Absent an exception, an issuer would need to register as an investment company if either it is engaging or proposes to engage (1) primarily in the business of investing, reinvesting or trading in securities, or (2) in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire investment securities with a value exceeding 40 percent of its total assets, exclusive of government securities and cash items, on an unconsolidated basis. If the structure of a future opportunity zone investment is unknown, then it may be difficult not proposing to engage primarily in the business of investing in securities. Further, even where a significant part of an issuer's assets is directly owned, the second test may be incidentally tripped if the subsidiary's assets, net of cash and government securities, exceed 40 percent of the fund's assets and

the interests in that issuer are deemed securities, particularly in the early days of the fund when a significant amount of the fund's assets will be in cash items.

There are two exceptions from being deemed an investment company under the Investment Company Act of 1940 (Investment Company Act) that are available to typical real estate investment funds—Section 3(c)(1), or the "100 and under" exception, and Section 3(c)(7), or the "qualified purchaser" exception. The fund also may be exempt under Section 3(c)(5)(c) of the Investment Company Act. Section 3(c)(5)(c) exempts certain issuers that are primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate. The SEC requires that an entity relying on Section 3(c)(5)(c) for its Investment Company Act exemption have at least 55 percent of its portfolio invested in "qualifying assets" (which in general must consist of mortgage loans, mortgage backed securities that represent the entire ownership in a pool of mortgage loans and other liens on and interests in real estate) and another 25 percent of its portfolio invested in other real estate-related assets.

Determining whether a fund qualifies for the Section 3(c)(1) exception is not as simple as looking at the number of investors in the fund. Rather, a web of regulations, enforcement actions and interpretations has created many instances where the fund must "look through" an investor to its beneficial owners, or combine multiple investors into a single beneficial owner. Further, under some circumstances an owner and a beneficial owner may not even be the same thing.

The qualified purchaser exemption (Section 3(c)(7)) presents a much brighter line and eliminates the limit on the *number* of investors, but also places significant limitations on *who* may invest in the fund. The vast majority of qualified purchasers are individuals who own greater than $5,000,000 of investments and entities that own and invest on a discretionary basis not less than $25,000,000 of investments—a threshold that is not easily reached, particularly given the nuanced definition of "investments."[17]

In addition, investment funds that do not need to register solely because of an exception under Section 3(c)(1) or 3(c)(7) of the Investment Company Act generally are "covered funds" under the "Volcker Rule."[18] The Volcker Rule severely limits the ability of many banks and other regulated financial institutions to make investments for their own account in 3(c)(1) and 3(c)(7) funds. Typically, tax credit funds would qualify for the "public welfare" exemption[19] from being a covered fund. It is unclear, however, whether all O-funds would fall within this exemption. This may present important structural issues where the targeted investor base consists of large financial institutions and insurers. Conversely, this also may expand the potential investor base for traditional real estate fund managers, as many O-funds, such as those that invest in low-to-moderate income housing, likely would fall within the exemption.

Are You an Investment Adviser?

An investment adviser includes anyone who, for compensation, is engaged in the business of providing advice to others or issuing reports or analyses regarding securities, subject to limited exceptions.[20] Advising a fund itself does not necessarily make one an investment adviser. In fact, a qualified opportunity zone fund might not be a fund at all—it could be a direct investment by a single person that wants to operate a business in the opportunity zone. If the fund's assets are not deemed securities, then the sponsor would not be giving advice regarding securities. That said, if the fund's portfolio consists of securities and the manager is engaged in the business of advising that fund for compensation, then it would be an investment adviser.

All investment advisers, whether or not they are required to register, are subject to the antifraud provisions of the Investment Advisers Act of 1940 (Advisers Act) and are subject to a fiduciary duty under the Advisers Act to act in the best interest of their clients. This fiduciary duty extends to many items that would not be included in the fiduciary

duties of a general partner or managing member under most state laws, including duties to fully disclose all material facts, ensure that advice is suitable to the client, have a reasonable basis for any recommendation, provide for best execution and vote portfolio securities in the best interests of the client.

Do You Need to Register as an Investment Adviser, and If So, Where?

Determining investment adviser registration requirements is highly dependent on the manager's location, the amount of assets under management and the nature of the accounts that it manages. The Advisers Act regime is fairly unique among securities laws in that, for the most part, an adviser is exclusively subject to the substantive provisions of either federal or state investment advisory laws, but not both. While there are numerous exceptions, the general rule of thumb is that if the manager has less than $100 million of assets under management, it is subject to state registration, and if it has greater than $110 million of assets under management, it is subject to federal registration (with special rules applying in that gray area).[21] A significant exception to that is that the federal jurisdiction threshold is only $25 million of assets under management for managers located in New York or Wyoming. Calculating assets under management is set by regulation and differs significantly from how one might calculate assets under management for accounting or track record purposes.

Certain managers may be able to qualify for a limited exemption from the Advisers Act known as the private fund adviser exemption.[22] U.S.-based managers can rely on this exemption where the adviser acts solely as an adviser to private funds, such as Section 3(c)(1) and 3(c)(7) funds, and has less than $150 million of assets under management attributable to those private funds. That said, managers cannot rely on this exemption to the extent they would be required to register at the state level. Further, while this exemption preempts most of the substantive requirements of the Advisers Act, a manager relying on this exemption would still be an "exempt reporting adviser" that needs to file an abbreviated version of Form ADV, is subject to SEC examinations and is still subject to certain substantive provisions of the Advisers Act, including pay-to-play rules that may limit the ability of the firm and its associates to make political contributions.

Can You Market a Qualified Opportunity Zone Fund in the Same Way as a Tax Credit Fund?

Maybe. An O-fund might only or primarily own assets that are not deemed to be securities, in which case there are unlikely to be significant differences in how the fund would be marketed versus a tax credit fund as both would be required to comply with the exemptive and antifraud provisions of securities laws. On the other hand, if the sponsor will be an investment adviser, there would be an additional fiduciary duty of full disclosure under the Advisers Act, including complete transparency about fees and expenses as well as conflicts of interest. Further, investment advisers that are registered or required to be registered are subject to the Advisers Act "advertising rule," which places many restrictions on the ability of the adviser to advertise track record, include testimonials, use benchmarks or discuss prior investments. This could have a major effect on the look and feel of an offering document and, in the era of social media, this may require some managers to re-evaluate their overall marketing strategy.

Can You Be Compensated the Same Way as a Tax Credit Fund?

Also maybe. Real estate managers often take a fee for structuring and negotiating an underlying investment. If the underlying investment is a security, then a transaction-based fee could be illegal without registration as a securities broker-dealer. In addition, registered investment advisers are not permitted to accept performance fees, such as promote or carried

interest, unless all of the fund's investors are qualified clients. The threshold for being a qualified client is significantly higher than that of an accredited investor, but significantly lower than that of a qualified purchaser.

In addition, each state has laws defining broker-dealer, agent and related registration requirements and, as noted above, states may regulate investment advisers as well. Under the Uniform Securities Act, adopted in large measure by many states, an issuer selling its own securities is exempt from broker-dealer registration. An employee or other individual who represents an issuer may also be exempt if no commission or other remuneration is paid for soliciting investors. On the other hand, there is no such exemption in a number of states. Accordingly, any state in which offers and sales are to be made should be checked to ensure compliance.

What Else Is Needed to Comply with the Investment Advisers Act?

In addition to rules relating to advertising and compensation, registration under the Advisers Act subjects the manager to an entirely separate regulatory regime. Other significant requirements relate to, among other things: annual filing of a complete Form ADV; a delivery requirement for the Part 2 of Form ADV brochure, which in many ways is similar to a prospectus; recordkeeping, custody of assets, examinations by federal regulators, "pay-to-play" rules, significant restrictions on certain types of related-party transactions, requirements for use of solicitors, additional privacy laws, restrictions on changes in control, adhering to a code of ethics and a requirement to maintain and enforce a set of supervisory policies and procedures reasonably designed to prevent violations of applicable laws.

Notes

1. BUDGET FISCAL YEAR, 2018, Pub. Law No. 115-97, Dec. 22, 2017, 131 Stat. 2054.
2. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293 (1946).
3. *See United Housing Found., Inc. v. Forman*, 421 U.S. 837.
4. *See Sec. & Exch. Comm'n v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476, 482 (9th Cir. 1973).
5. *See* Pacesetter I L.P., 1986 WL 67085, at *1 (S.E.C. No-Action Letter July 18, 1986).
6. *See* 15 U.S.C. § 80b-2(a)(18).
7. *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967).
8. *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 299 (1946).
9. *See Shinn v. Thrust IV, Inc.*, 786 P.2d 285, 297-298 (Wash. Ct. App. 1990).
10. *See Mayer v. Oil Field Systems Corp.*, 721 F.2d 59 (2d Cir. 1983); *see also Shinn*, 786 P.2d at 297.
11. *See S.E.C. v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007); *see also Mayer*, 721 F.2d 59.
12. *Mayer*, 721 F.2d at 65.
13. *See Gordon v. Terry*, 684 F.2d 736, 741 (11th Cir. 1982).
14. *Steinhardt Group, Inc. v. Citicorp*, 126 F.3d 144 (3d Cir. 1997).
15. *See Marine Bank v. Weaver*, 455 U.S. 551, 560 (1982).
16. *Steinhardt Group, Inc.*, 126 F.3d at 153 - 154; *Bank of Am. Nat'l Trust and Sav. Ass'n, Inc. v. Hotel Rittenhouse Assoc.*, 595 F. Supp. 800 (E.D.P.A. 1984); *Gordon*, 684 F.2d at 74.
17. 17 C.F.R. § 270.2a51-1(b).
18. 12 C.F.R. § 248.10(b)(1)(i).
19. 12 C.F.R. § 248.10(c)(11)(ii)(A).
20. 15 U.S.C § 80b-2(a)(11).
21. *See* 15 U.S.C. § 80b-3 (Dodd-Frank Act § 410); 17 C.F.R. § 275.203A-1.
22. 17 C.F.R. § 275.203(m)-1.