

## **FRANK MASON - REGISTRATION OF AN INVESTMENT CLUB**

**Publicly Available July 3, 1996**

### **SEC LETTER**

**Advisers Act Sec. 203(a)**

**Investment Company Act Sec. 3(a)(1)**

**July 3, 1996**

**Mr. Frank Mason**

**618 Woodduck Lane**

**Georgetown, KY 40324**

Dear Mr. Mason:

This letter is in response to your letter dated June 11, 1996, requesting information regarding registration of an investment club with the Securities and Exchange Commission ("Commission"). You also request information regarding the formation of a mutual fund.

The initial question that must be considered is whether the proposed investment club has an obligation to register with the Commission as an "investment company" under the Investment Company Act of 1940 ("1940 Act").<sup>1</sup> Generally, most investment clubs are not required to register as investment companies, either because the club does not issue interests that are "securities," or because the club's membership interests are privately offered and are held by not more than one hundred persons.

An investment club will be required to register under the 1940 Act only if (1) the club invests in securities, (2) it issues membership interests that are themselves securities, and (3) no exclusion from the definition of investment company is available. Assuming that the proposed investment club will invest in securities, the next question to be addressed is whether its membership interests are themselves securities.

A membership interest in an investment club would be a security if it is an "investment contract." To determine whether an investment contract exists, we look to the "presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."<sup>2</sup> If every member of an investment club actively participates in managing the club, the membership interests in the club would not be securities because each member would not rely solely on the efforts of others. Therefore, the investment club would not be an investment company subject to regulation under the 1940 Act. However, if the club consisted of even a few passive members, it may be issuing securities.

Even if the club's membership interests are securities, many clubs rely on the "private investment company" exclusion from the definition of investment company. Section 3(c)(1) of the 1940 Act excludes from regulation any issuer that is not making and does not propose to make a public offering of its securities and whose securities are owned by one hundred or fewer shareholders.<sup>3</sup> I have enclosed for your information a copy of the Commission's Investment Company Registration Package which includes a Commission release discussing when a public offering exists.<sup>4</sup>

If, however, you wish to form a mutual fund and offer its shares to the public, you will need to comply with the requirements of the 1940 Act and the Securities Act of 1933 ("1933 Act"). A public mutual fund must register as an investment company with the Commission under the 1940 Act, and if it is publicly offering its securities, must register those securities under the 1933 Act. The 1940 Act, among other matters, limits transactions between an investment company and its affiliates, contains provisions that govern the company's capital structure, and sets forth requirements regarding the composition of the company's board of directors and the purchase and redemption of the company's shares. The 1940 Act also requires that an investment company have a net worth of at least \$100,000 in total assets before it can offer its securities to the public. The enclosed Investment Company Registration Package includes additional information on investment company regulation as well as the form that must be filed to register.

You should also be aware that a person selecting the investments for a registered investment company generally is required to register as an investment adviser under the Investment Advisers Act of 1940 ("Advisers Act"), and that a person selecting investments for an investment club may also be required to register as an investment adviser. Section 202(a)(11) of the Advisers Act generally defines an investment adviser as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

Section 203(a) of the Advisers Act requires an investment adviser to register with the Commission unless exempt from registration under Section 203(b) of the Advisers Act. Section 203(b)(3) exempts from registration any investment adviser who, during the course of the preceding twelve months, has had fewer than fifteen clients, does not hold himself out to the public as an investment adviser, and does not act as an investment adviser to any registered investment company.<sup>5</sup> Any person that meets the definition of investment adviser, regardless of whether or not he is required to register, must comply with the antifraud provisions of the Advisers Act.<sup>6</sup> I have enclosed with this letter a copy of the Commission's Investment Adviser Registration Package, which discusses the definition of an investment adviser in more detail, and contains the forms necessary to register as an investment adviser should you determine it necessary to do so.

In addition, you should contact the appropriate state authority (or authorities) to determine what, if any, state requirements may apply to your proposed activities. The names and addresses of appropriate state officials can be obtained by contacting the North American Securities Administrators Association, Inc., One Massachusetts Avenue, N.W., Suite 310, Washington, D.C. 20001, Telephone: (202) 737-0900. Due to the complexity of investment company and investment adviser regulation, you also may wish to consult with an attorney familiar with this area before proceeding.

I hope that you find this information helpful. If you have any further questions, please contact this office at (202) 942-0659.

Sincerely,

Sanjay Lamba  
Law Clerk

#### **Footnotes**

1 Section 3(a)(1) of the 1940 Act defines "investment company" as "any issuer which is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading securities." The term "issuer" is defined in section 2(a)(22) as "every person who issues or proposes to issue any security, or has outstanding any security which it has issued."

2 United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 (1975).

3 In your letter, you refer to an investment club with more than twenty-five members being required to register with the Commission. As noted above, the 1940 Act specifies that the limit on the number of investors in a private investment company is one hundred, not twenty-five.

4 See Securities Act Release No. 4552 (Nov. 6, 1962).

5 A person holds himself out to the public as an investment adviser if, among other things, he uses such terms as "investment adviser" or "investment manager" on his stationery or in a business or telephone directory, or lets it be known, by word of mouth through existing clients or otherwise, that he is willing to take on new advisory clients. George J. Dippold (pub. avail. May 7, 1990).

6 See Section 206 of the Advisers Act.

**INCOMING LETTER**

**June 11, 1996**

**Securities Exchange Commission  
Office of Chief Council  
Division of Investment Management  
450 Fifth St. NW  
Washington, DC 20549**

To Whom It May Concern:

If this is not addressed to the correct office, please forward it to the appropriate office. Thank you.

I am requesting information on two issues.

1) I have been informed that investment clubs with more than twenty-five members need to be registered with the SEC. Please provide me with the necessary information so that I can comply.

2) I am interested in exploring the formation of a mutual fund. Please send the information detailing restrictions and regulations and the necessary forms for registration.

Thank you.

Sincerely,

Frank Mason  
618 Woodduck Lane  
Georgetown, KY 40324