SEC CONSIDERATIONS – INVESTMENTS IN PRIVATE SECURITIES

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ABSTRACT

Investments in private markets are becoming an essential piece of any balanced and diversified portfolio, particularly for ultra-high net worth individuals and families. Further, Ernst & Young, one of the "big 4" accounting firms, estimates that assets under management in private markets more than doubled from $9.7 trillion in 2012 to $22.6 trillion in 2022. This sustained growth is poised to continue alongside a projected $72.6 trillion in assets to be transferred to heirs through 2045, in other words, the largest intergenerational transfer of wealth in history. Given the massive projected increase in wealth transfers and the sustained growth of private securities in the last decade, trust and estate lawyers should become familiar with the laws and regulations that govern alternative investments in private securities.

This article examines the three common thresholds that issuers of private securities commonly require investors to meet and how different structures of trusts may seek to meet those thresholds: (1) the accredited investor threshold under the Securities Act of 1933, (2) the qualified purchaser threshold under the Investment Company Act of 1940 and (3) the qualified client threshold under the Investment Advisers Act of 1940.

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Given the massive projected increase in wealth transfers for the near future and the sustained growth of private securities in the last decade, trust and estate lawyers should become familiar with the laws and regulations that govern alternative investments in private securities. For instance, all private securities avail themselves of the private offerings available under the Securities Act of 1933 (the "***Securities Act***"). Additionally, many private securities avail themselves of exemptions under the Investment Company Act of 1940 (the "***Investment Company Act***"), and SEC-registered investment advisers charging performance-based fees must be mindful of specific provisions in the Investment Adviser Advisers Act of 1940 (the "***Advisers Act***").

This article will highlight three common thresholds that a trust may need to meet in order to invest in private securities under the Securities Act, the Investment Company Act and the Advisers Act. First, a trust may seek to qualify as an "accredited investor" under the Securities Act. Second, a trust may seek to qualify as a "qualified purchaser" under the Investment Company Act. Third, a trust may seek to qualify as a "qualified client" under the Advisers Act.

I. THE SECURITIES ACT

Under the Securities Act, an issuer of securities must either (i) file a registration statement with the U.S. Securities and Exchange Commission (the "***SEC***"), which is often prohibitively expensive and time-consuming, or (ii) satisfy an exemption from registration.[4]

"***Regulation D***" provides exemptions to issuers of private securities from the Securities Act's registration requirement.[5] Currently, Regulation D is composed of Rules 504[6] and 506.[7] Many issuers of private securities rely on Rule 506 to exempt the issuer and the first offering of the private securities from registration.[8] Subject to limitations imposed by other laws, such as the 2000-investor limit under the Securities Exchange Act of 1934, an unlimited number of "accredited investors" may invest in private securities offered under Rule 506(b) and 506(c).[9] This section will focus on the "accredited investor" threshold under the Securities Act.

A. Issuers Often Require Each Investor to Qualify as an "Accredited Investor"

Issuers of private securities often require each investor to represent it is an "accredited investor" under the Securities Act. The SEC describes an accredited investor as a natural person or entity that is "financially sophisticated and able to fend for themselves or sustain the risk of loss, thus making protections that come from

[1] Ryan Burke, *Are You Harnessing the Growth and Resilience of Private Capital?*, Ernst & Young (Apr. 4, 2024).

[2] *Id.*; *Will the 'Great Wealth Transfer' transform the markets?*, Merrill Lynch (last visited Apr. 28, 2024) (citing *The Cerulli Report: U.S. High-Net-Worth and Ultra-High-Net-Worth Markets 2021,* Cerulli Associates).

[3] Talmon Joseph Smith & Karl Russell, *The Greatest Wealth Transfer in History Is Here, With Familiar (Rich) Winners*, New York Times (May. 14, 2023).

[4] 15 U.S.C. § 77e(a) (The Securities Act provides that, unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—(1) to make use of any means or instruments or transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise or (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or delivery after sale.).

[5] The SEC designed Regulation D in 1982 "to simplify existing rules and regulations, to eliminate any unnecessary restrictions that those rules and regulations place on issuers, particularly small businesses, and to achieve uniformity between state and federal exemptions in order to facilitate capital formation consistent with the protection of investors." SEC, Securities Act Release No. 6389 (Mar. 8, 1982).

[6] 17 C.F.R. § 230.504 (informally known as Rule 504).

[7] *Id.* at § 230.506 (informally known as Rule 506).

[8] *Private Placements under Regulation D – Investor Bulletin*, SEC (Aug. 17, 2022) (According to the SEC, "[m]ost private placements are conducted pursuant to Rule 506."); *see* §§ 230.504, 230.506 (Private fund issuers less commonly rely on Rule 504 because, among other things, an issuer may only sell $10,000,000 of securities during any twelve-month period.). Importantly, each secondary sale of a security originally offered pursuant to an exemption from registration must also be registered with the SEC or be sold pursuant to an exemption. 15 U.S.C. § 77e(a).

[9] 17 C.F.R. § 230.506(b)-(c).

a registration unnecessary."[10] An investor may meet certain quantitative tests where a qualifying investor is presumed to possess the "financial sophistication" required to be an accredited investor.

A natural person is an accredited investor if they have a net worth of over $1 million, individually or jointly with a spouse (excluding the individual's primary residence and any related debt).[11] A natural person is also an accredited investor if they have an income of over $200,000 for the preceding two years, or over $300,000 of joint income with that person's spouse or spousal equivalent.[12] And, generally, an entity is considered an accredited investor if it has assets over $5 million.[13] However, the SEC has recently considered raising both the net worth and net income thresholds.[14]

B. Generally, a Trust Qualifies as an Accredited Investor in Three Scenarios

First, a trust qualifies as an accredited investor if the trust (i) has over $5 million in assets, (ii) was not formed for the specific purpose of acquiring the securities offered and (iii) is directed by a sophisticated person to purchase the securities offered.[15]

Whether an entity is formed for the specific purpose of acquiring the securities offered is a question of facts and circumstances.[16] The SEC has provided useful color that, while no factor is dispositive, some significant factors include: "[(i)] the existence and nature of prior activities by the entity, [(ii)] the structure of the entity (*i.e.*, whether the entity has centralized management and decision-making), [(iii)] the proposed activities of the entity, [(iv)] the relationship between the entity's investment in the Regulation D offering and the entity's capitalization, and [(v)] the extent to which all equity owners of the entity participate in all investments by the entity."[17]

For these purposes, a "sophisticated person" is either (i) an accredited investor or (ii) a non-accredited investor who "has such knowledge and experience in financial and business matters that [they] are capable of evaluating the merits and risk of the prospective investment."[18]

Second, a trust qualifies as an accredited investor if a bank serves as the trustee of the trust and if the bank makes the investment on behalf of the trust.[19] The SEC has provided that it views "a trust having a bank as a co-trustee" as an accredited investor "so long as the bank is 'acting' in its fiduciary capacity on behalf of the trust, *i.e.*, in reference to the investment decision and the trust follows the bank's direction."[20]

Third, the test for whether a grantor trust qualifies as an accredited investor depends on whether the trust is revocable or irrevocable.[21] On one hand, a *revocable* grantor trust is an accredited investor if (i) the grantors, in their capacities as individuals, independently qualify as accredited investors,[22] (ii) the trust is revocable (may be revoked or amended at any time by the grantors)[23] and (iii) the grantors are the sole beneficiaries of trust.[24]

On the other hand, an *irrevocable* grantor trust may be an accredited investor if (i) the trust is a grantor trust for federal tax purposes and the grantor was the sole source of funds; (ii) the grantor is a trustee of the trust and has total investment discretion at the time an investment decision is made; (iii) the trust's terms provide that the grantor's entire contribution to the trust, plus a fixed rate of return on the contribution, will be paid to the grantor before any payments are made to the trust's beneficiaries; (iv) the trust was established by the grantor for family estate planning purposes to help with the distribution of the grantor's estate; and (v) the grantor's creditors are able to reach the grantor's interest in the trust (at all times).[25] Again, this determination is fact specific.[26]

Depending on which exemption an issuer relies on, the issuer may be required to take affirmative steps

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[10] *See Accredited Investors – Updated Investor Bulletin*, SEC (Apr. 14, 2021).

[11] 17 C.F.R. § 230.501(a)(5).

[12] *Id.* at § 230.501(a)(6).

[13] *Id.* at § 230.501(a)(3).

[14] *Review of the 'Accredited Investor' Definition under the Dodd-Frank Act*, SEC (Dec. 14, 2023).

[15] 17 C.F.R. § 230.501(a)(7).

[16] Hall Moneytree Assoc. Ltd. P'ship I, SEC Staff No-Action Letter, 1983 WL 29899 (Oct. 3, 1983).

[17] *Id.*

[18] 17 C.F.R. § 230.506(b)(2)(ii).

[19] Interpretive Release on Regulation D, SEC, Securities Act Release No. 6455 (Mar. 3, 1983) at Q. 26.

[20] Nemo Capital Partners, L.P., SEC Staff No-Action Letter, 1987 SEC No-Act. LEXIS 1932 (Mar. 11, 1987).

[21] Lawrence B. Rabkin, SEC Staff No-Action Letter, 1982 SEC No-Act. LEXIS 2690 (Aug. 16, 1982).

[22] 17 C.F.R. § 230.501(a)(8); *Securities Act Rules*, SEC (November 20, 2023) at Q 255.21. (November 20, 2023).

[23] Lawrence B. Rabkin, SEC Staff No-Action Letter, 1982 SEC No-Act. LEXIS 2690 (Aug. 16, 1982).

[24] *See id.*

[25] Herbert S. Wander, SEC Staff No-Action Letter, 1983 SEC No-Act. LEXIS 3005 (Nov. 25, 1983).

[26] Hall Moneytree Assoc. Ltd. P'ship I, SEC Staff No-Action Letter, 1983 WL 29899 (Oct. 3, 1983).

to verify an investor's status as an accredited investor. Under Rule 506(b), an issuer must have a "reasonable belief" that an investor is an accredited investor. [27] However, under Rule 506(c), issuers must take "reasonable steps" to verify an investor's status as an accredited investor.[28] As a part of taking "reasonable steps," an issuer of private securities may ask to see an investor's tax returns, pay stubs, bank statements or other financial documents to verify an investor's income or assets.[29] Alternatively, a privacy-oriented investor, including many trusts, may wish to rely on third-party verification, where a registered broker-dealer, an SEC-registered investment adviser, a licensed attorney or a certified public accountant confirms in writing that such person has verified the investor is an accredited investor after having taken "reasonable steps" like reviewing the investor's financial documents.[30]

II. THE INVESTMENT COMPANY ACT

Second, a trust acquiring private securities from an issuer relying on the Section 3(c)(7) exemption from the Investment Company Act will need to meet the "qualified purchaser" threshold. This threshold is much higher than the accredited investor threshold. Generally, the Investment Company Act requires "investment companies"[31] to register with the SEC.[32] However, private offerings usually rely on an exemption from regulation under the Investment Company Act, such as sections 3(c)(1) and 3(c)(7).

Section 3(c)(1) excludes from the definition of investment company an entity whose outstanding securities are beneficially owned by 100 persons or less and which is not making, or does not intend to make, a public offering of its securities.[33]

Section 3(c)(7) is a popular exemption for issuers targeting institutional capital or ultra-high net worth investors. Section 3(c)(7) excludes an entity from the definition of investment company whose outstanding securities are beneficially owned only by "qualified purchasers" and which is not making, or does not intend to make, a public offering of its securities.[34] In other words, subject to limitations imposed by other laws, an issuer relying on the Section 3(c)(7) exemption may accept an unlimited number of qualified purchasers as investors.

A. There are Four Categories of "Qualified Purchasers"

Under the Investment Company Act, the definition of a qualified purchaser breaks down into four categories: (i) a natural person who owns at least $5 million of investments[35] (either individually or jointly with a spouse),[36] (ii) a "family company"[37] (including a trust qualifying as a family company) that owns at least $5 million of investments,[38] (iii) a trust (other than a trust that is a family company owning $5 million in investments) that was not formed for the specific purpose of buying securities,[39] of which both the settlor or other person who has contributed assets to the trust and any trustee or other person which controls the investment decisions of the trust is a qualified purchaser[40] and (iv) any person, acting for its own account or the accounts of other qualified purchasers, who, in the aggregate, owns and invests on a discretionary basis, not less than $25,000,000 in investments.[41]

B. Generally, a Trust Qualifies as a Qualified Purchaser in Three Ways

First, a trust is a qualified purchaser if it acts on its own account or the accounts of other qualified purchasers, who, in the aggregate, own and invest at least $25 million on a discretionary basis.[42] However, a trust must independently meet the qualified purchaser threshold, even if the trustee of such trust is a qualified

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[27] 17 C.F.R. § 230.506(b).

[28] *Id.* at § 230.506(c)(2)(ii).

[29] *Id.*

[30] *Id.* at § 230.506(c)(2)(ii)(C).

[31] 15 U.S.C. § 80a-3(a)(1) (Under the Investment Company Act, an "investment company" is, among other things, an issuer engaging in or proposing to engage in the business of investing, reinvesting or trading in securities.).

[32] *Id.* at § 80a-7(a) ("No investment company organized or otherwise created under the laws of the United States or a State . . . unless registered under section 80a-8 of this title, shall" among other things, "offer for sale . . . any security or any interest in a security. . . .").

[33] *Id.* at § 80a-3(c)(1). *See also* Handy Place Inv. P'ship, SEC Staff No-Action Letter, 1989 SEC No-Act. LEXIS 850 (Jul. 19, 1989); Nemo Capital Partners, L.P., SEC Staff No-Action Letter, 1987 SEC No-Act. LEXIS 1932 (Mar. 11, 1987); OSIRIS Mgmt., Inc., SEC Staff No-Action Letter, 1984 SEC No-Act. LEXIS 1966 (Feb. 17, 1984).

[34] 15 U.S.C. § 80a-3(c)(7).

[35] 17 C.F.R § 270.2a51-1(b).

[36] 15 U.S.C. at § 80a-2(a)(51)(A)(i).

[37] *Id.* at § 80a-2(51)(A)(ii)

[38] *Id.* at § 80a-2(a)(51)(A)(ii).

[39] Hall Moneytree Assoc. Ltd. P'ship I, SEC Staff No-Action Letter, 1983 WL 29899 (Oct. 3, 1983).

[40] 15 U.S.C. § 80a-2(a)(51)(A)(iii).

[41] *Id.* at § 80a-2(a)(51)(A)(iv).

[42] *Id.* at § 80a-2(a)(51)(A)(iv).

purchaser.[43]

Second, a trust that is a "family company," meaning it has been established for the benefit of two or more individuals related as siblings, spouses (including former spouses), direct lineal descendants by birth or adoption or the spouses of such persons[44] is a qualified purchaser if it holds at least $5 million of "investments."[45]

Third, a trust that is not a "family company" is a qualified purchaser only if each trustee or other person authorized to make decisions concerning the trust and each settlor or other person who has contributed assets to the trust is considered a qualified purchaser.[46]

Unlike the accredited investor rules discussed above, a bank-trustee's status alone will not qualify the trust as a qualified purchaser. Also, unlike the accredited investor rules discussed above, securities transferred by a qualified purchaser are treated as if they are still owned by a qualified purchaser.[47]

III. THE ADVISERS ACT

Finally, the Advisers Act may require an investor acquiring private securities to be a "qualified client." The Advisers Act governs the operation of "investment advisers." An "investment adviser" is a person who, among other things, advises others as to the value of securities or as to the advisability of investing in, purchasing or selling securities for compensation.[48]

As a general rule, it is illegal for an investment adviser, unless registered or exempt from registration, "to make use of the mails or any means or instrumentality of interstate commerce in connection with [its] business as an investment adviser."[49] Given the broad reading given to the phrase "any means or instrumentality of interstate commerce," a person that provides advice as to securities for compensation generally must register as an investment adviser or operate under an exemption from registration.[50]

For context, many investment advisers charge what is known as the "2/20" fee model, where the adviser receives 2% of the assets under management (a management fee) and 20% of the profits in a given year (a performance allocation)—though these numbers depend on the adviser. Both the management fee and performance allocation squarely place the person in the definition of an investment adviser under the Advisers Act—the logic being that the investment manager provides investment advice to a third-party such as a hedge fund (by picking investments) in exchange for compensation (the management fee and performance allocation). Based on the size of an investment adviser's assets under management, an investment adviser may register with the SEC, a state, or operate under an exemption from registration.

Generally, the Advisers Act prohibits SEC-registered investment advisers from entering into or performing any investment advisory contract that provides performance fees (*e.g.*, performance allocations) as compensation for the adviser.[51] SEC-registered investment advisers can only charge performance-based fees to "qualified clients;"[52] this is in contrast with state-registered investment advisers (which, depending on state law, may or may not require a state-registered investment adviser charging performance-based fees to do so of qualified clients) and exempted reporting advisers.

If an investor is a qualified purchaser under the Investment Company Act, it is also a qualified client under the Advisers Act.[53] An investor that is not a qualified purchaser can meet the qualified client threshold through an assets-under-management test or a net worth test.[54]

Under the assets-under-management test, an investor is a qualified client if the SEC-registered investment adviser manages at least $1.1 million of the investor's money after entering into an advisory contract with the investor.[55] Under the net worth test, an SEC-registered investment adviser must "reasonably believe[], immediately prior to entering into the contract,"[56] that the investor has a "net worth of more than $2.2 million."[57] Natural persons and entities, including trusts,[58] may satisfy either the assets-under-management test or the net worth test.[59]

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[43] *Id.*

[44] *Id.* at § 80a-2(51)(A)(ii).

[45] *Id.*

[46] 15 U.S.C. § 80a-2(a)(51)(A)(iii).

[47] *Id.* at § 80a-3(c)(7)(a).

[48] *Id.* at § 80b-2(a)(11).

[49] *Id.* at § 80b-3(a).

[50] *Id.* at § 80b-2(a)(11).

[51] 15 U.S.C. § 80b-5(a)(1).

[52] 17 C.F.R. § 275.205-3(a).

[53] *Id.* at § 275.205-3(d)(1)(ii)(B).

[54] *Id.* at § 275.205-3.

[55] *Inflation Adjustments of Qualified Client Thresholds*, SEC (Jun. 17, 2021).

[56] 17 C.F.R. § 275.205-3.

[57] *Inflation Adjustments of Qualified Client Thresholds*, SEC (Jun. 17, 2021).

[58] 15 U.S.C. § 80b-2(a)(5).

[59] 17 C.F.R. § 275.205-3(d)(1).

IV. CONCLUSION

Given that analysts predict the largest intergenerational transfer of wealth ever to occur over the next few decades, we will likely see a commensurate increase in trusts acquiring private securities. Advisors to trusts should bear the accredited investor, qualified purchaser and qualified client thresholds in mind when advising how to structure a trust that may seek to invest in private securities.

A trust is a useful tool to facilitate both wealth transfers and investments in private securities, provided that parties structure the trust for compliance with the Securities Act, the Investment Company Act, the Advisers Act and other laws that may apply to investments in private securities such as the Securities Exchange Act of 1940.