Complex Securities Laws and the Eligibility of Trusts to Make Alternative Investments

By Stacy K. Mullaney

With the adoption of the Uniform Prudent Investor Act (UPIA), promulgated by the National Conference of Commissioners on Uniform State Laws in 1994, a broadened and diversified world of investing was opened up to trust fiduciaries. Replacing the former "prudent man rule," the UPIA reflects a "modern portfolio theory" and "total return" approach to the exercise of fiduciary investing and removes many of the common law restrictions on the investment authority of fiduciaries. With the shift to modern portfolio theory investment strategies under the UPIA, no category or type of investment is deemed imprudent per se. In fact, an appropriate asset allocation and diversification strategy (one that maximizes return while minimizing risk and volatility) can include investments in derivatives, futures, commodities, and other investments that may hedge investment risk. Most commonly, access to these types of investments is through unregistered limited partnerships and other private investment vehicles. For the trustee and the legal professional advising the trustee, this requires an understanding of federal and state securities laws and regulations governing such investments to assess and advise whether a trust is legally permitted to make an investment in such an investment vehicle.

The Framework of Securities Regulation

Securities transactions are subject to regulation under both federal and state laws. The purpose of these laws is to ensure that investors have been provided sufficient financial and other information about the security being offered as well as the financial condition and investment policies of the issuer so that investors can make knowledgeable and informed investment decisions. In

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Edgar Degas, *Portraits at the Stock Exchange: Ernest May, financier and collector*, 1878–79.

addition, laws and regulations are in place to prevent deceit, misrepresentation, and fraud in the sale of securities. Although many laws govern the securities industry, this article focuses on the federal laws in this area, specifically on the Securities Act of 1933 (the "1933 Act") and the Investment Company Act of 1940 (the "1940 Act").

The 1933 Act regulates public offerings of securities. It prohibits offers and sales of securities that are not registered with the Securities and Exchange Commission (SEC), unless exempted from registration in accordance with the 1933 Act. Underlying the 1933 Act is the idea that an "issuer" offering securities should provide potential investors with sufficient information about both the issuer and the securities offered by the issuer to make an informed investment decision. The 1933 Act requires issuers publicly to disclose significant information about themselves and the terms of the securities.

The 1940 Act regulates investment advisors. Investment advisors are companies, including mutual funds, that engage primarily in investing, reinvesting, and trading in securities and whose own securities can be offered to the investing public. The 1940 Act requires these companies to register with the SEC and to disclose their financial condition and investment policies to investors when their stock is initially sold and to update such information regularly thereafter. The focus of the 1940 Act is on disclosure to the investing public of information about the fund and its investment objectives, as well as on investment company structure and operations.

As noted above, the 1933 Act and the 1940 Act govern the registration of certain securities and issuers with the SEC. Both of these Acts, however, provide various exemptions from registration for certain securities and certain issuers. In the case of the 1933 Act, Regulation D contains three rules (Rules 504, 505, and 506) providing exemptions from securities registration requirements, allowing some companies to offer and sell their securities without having to register the securities with the SEC. Specifically, Rule 506 permits an unlimited offering of unregistered securities to certain sophisticated investors defined as "accredited investors." In the case of the 1940 Act, section 3(c)(7)(A) exempts from the definition of investment company any issuer whose securities are owned exclusively by sophisticated investors defined as "qualified purchasers."

Trust Investments in Unregistered Private Investment Vehicles

Trustees and advisors of trusts with certain minimum asset values should consider unregistered private investment vehicles (such as limited partnerships) as a potential component of a well-diversified portfolio. In addition to broadening diversification, private investment vehicles may provide an opportunity to enhance returns as well as reduce the overall risk of the portfolio. These vehicles can provide access to asset classes such as commodities, currencies, global bonds, real estate, and private equities.

Private investment vehicles and partnerships avoid SEC registration by limiting their securities offerings to accredited investors and/or qualified purchasers. For the trustee and the advisor to the trustee, the key to understanding whether a trust can invest in such private investment vehicles is knowing whether a trust meets the requirements of an accredited investor or qualified purchaser.

The Accredited Investor

An issuer of securities will often seek to avoid registration of its securities under the 1933 Act by limiting the securities offering to purchasers that are "accredited investors." Under Rule 506 of Regulation D, an issuer can sell an unlimited amount of securities to any number of accredited investors while being exempt from the registration requirements of the 1933 Act. Under Rule 501, an accredited investor is defined as any person that comes within eight categories, or whom the issuer reasonably believes comes within those categories, at the time the securities are sold. The eight categories are aimed at identifying individuals and entities having the requisite sophistication to invest in higher risk assets without the need for the information and disclosures an issuer must make in a registered public offering of its securities. These investors are deemed to be sophisticated enough to understand the nature of the risk, the limited liquidity of the investment, and the characteristics of the deal such that they can evaluate the merits of the offering independently.

How Does an Irrevocable Trust Meet the Accredited Investor Requirement?

Whether an irrevocable trust is an accredited investor depends on the facts and circumstances. Because Rule 501 aims to identify those investors of a certain sophistication, it is understandable that a trust's qualification as an accredited investor will depend not on the sophistication of the beneficiaries but rather on the sophistication of those with authority to make the investment on behalf of the trust.

Trusts with Assets in Excess of $5 Million. Rule 501(a)(7) provides that an irrevocable trust can qualify as an accredited investor if the assets of the trust are in excess of $5 million, the trust was not formed for the purpose of acquiring the securities offered, and the purchase is directed by a "sophisticated person." A sophisticated person is described in Rule 506(b)(2)(ii) as a purchaser that, either alone or with a purchaser representative, has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of a prospective investment.

Trusts Managed by a Bank or Investment Company. Alternatively, a trust of any size can be an accredited investor under Rule 501(a)(1) as long as a bank, insurance company, registered investment company, business development company, or small business investment company is serving as a trustee or has authority to make investment decisions on behalf of the trust. The SEC has ruled that, although a trust standing alone may not be an accredited investor under Rule 501(a)(1), if a bank is its trustee and makes the investment on its behalf, the trust will be accredited by virtue of the bank's status as an accredited investor. See Interpretive Release on Regulation D, Rel. No. 33-6455, at Q.-26 (Mar. 10, 1983). The same is the case for a trust with a bank acting as co-trustee, as long as the bank is acting in its fiduciary capacity on behalf of the trust for investment decisions and the trust follows the bank's direction. See NEMO Capital Partners L.P., SEC No-Action Letter (Apr. 11, 1987).

How Does a Revocable Trust Meet the Accredited Investor Requirement?

A revocable trust can qualify as an accredited investor under Rule 501(a)(7) and 501(a)(1) similar to an irrevocable trust (see above). In addition, Rule 501(a)(8) provides that an entity in which all of the equity owners are accredited investors is an accredited investor. For an irrevocable trust, the beneficiaries are not considered to be "equity owners," so even if all of the beneficiaries are accredited investors, the trust is not an accredited investor. In the case of a revocable trust, if the trust is established by the grantor (often to facilitate the distribution of an estate in the event of death), and during the life of the grantor the trust may be amended or revoked by the grantor, and all the tax benefits from the investments made by the trust pass through to the grantor, then the grantor is considered the "equity owner"— and if the grantor (or each grantor, if more than one) is an accredited investor under Rule 501(a)(5) or Rule 501(a)(6) (that is, the grantor meets the net worth or income test), then the trust is an accredited investor. See Lawrence B. Rabkin, Esq., SEC No-Action Letter re: Rule 501(a) (8) of Regulation D (July 16, 1982).

Finally, there are some limited instances when the grantor of an irrevocable trust would be considered an equity owner of the trust under Rule 501(a)(8). In the case of a trust in which (1) the trust is a grantor trust for federal income tax purposes with the grantor as the sole funding source, (2) the grantor is the trustee with sole investment discretion, (3) the entire amount of the grantor's contribution plus a rate of return would be paid to the grantor before any other payments, and (4) the assets held by the trust are subject to the claims of the grantor's general creditors in the event of bankruptcy, the SEC has stated in an interpretive letter that the grantor of such a trust would be considered the equity owner, and if the grantor was an accredited investor, the trust would be an accredited investor. See Division of Corporate Finance Compliance and Disclosure Interpretations re: Securities Act Rules (last updated Sept. 14, 2009), citing Herbert S. Wander, SEC No-Action Letter (Nov. 25, 1983).

The Qualified Purchaser

Similar to the case in which an issuer of securities seeks to avoid registration of its securities under the 1933 Act, an issuer also can seek to avoid registration

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as an investment advisor by limiting securities offered to purchasers who are "qualified purchasers." Under section 3(c)(7)(A) of the 1940 Act, an issuer is excluded from the definition of an investment company, hence exempt from registration as an investment company, if the securities offered by the issuer are owned exclusively by persons who are qualified purchasers. The rationale here is similar to the rationale for exemption from registration under the 1933 Act. The SEC believes that if the offering is limited to sophisticated investors, those investors can adequately safeguard their interests without extensive federal regulation. There is a higher threshold for a qualified purchaser under the 1940 Act than for an accredited investor under the 1933 Act; however, net worth again serves as a proxy for sophistication. Section 2(a)(51)(A) of the 1940 Act created four categories of persons or entities who can be considered qualified purchasers: (1) individuals with at least $5 million in investments, (2) family-owned companies with at least $5 million in investments, (3) certain trusts in which the trustee and each settlor are qualified purchasers, and (4) companies with at least $25 million in investments.

How Does an Irrevocable Trust Meet the Qualified Purchaser Requirements?

For very large trusts with investments in excess of $25 million, section 2(a)(51)(A)(iv) of the 1940 Act can be applied. For irrevocable trusts with less than $25 million in investments, there are two primary means by which a trust can meet the requirements of a qualified purchaser. The requirements of section 2(a)(51)(A)(ii) of the 1940 Act and section 2(a)(51)(A)(iii) of the 1940 Act can be applied to an irrevocable trust.

Family-Owned Companies with at Least $5 Million in Investments. Section 2(a)(51)(A)(ii) of the 1940 Act provides that any company owning not less than $5 million in investments and owned directly or indirectly by two or more persons of a certain family relationship (or estates, organizations, or trusts established by or for the benefit of such persons) is a qualified purchaser. As used in section 2(a)(51)(A)(ii), "company" is defined in section 2(a)(8) of the 1940 Act to include a trust. In addition, Rule 2a51-1(b) generally defines "investments" as, among other things, certain securities, real estate held for investment purposes, commodities and interests therein, financial contracts, and cash and cash equivalents. It is important to note, however, that real estate used by the prospective qualified purchaser for personal purposes or, in some instances, as a place of business, is not considered real estate held for investment purposes.

The 1940 Act does not define who the "owners" of a company are; however, the Staff of the SEC (the "Staff") has stated that the beneficiaries of certain family trusts could be considered the "owners" for purposes of section 2(a)(51)(A)(ii) when those beneficiaries are the only persons holding economic interests in the trusts. Furthermore, the Staff stated in the Meadowbrook Real Estate Fund, SEC No-Action Letter (Aug. 26, 1998) ("Meadowbrook"), that it believed that Congress intended that all economic interests in a company relying on section 2(a)(51)(A)(ii) be held exclusively by persons who satisfy the family relationship requirements of that section. Therefore, in the case of a trust, all the beneficiaries of the trust must be related as siblings or spouses (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons.

Meadowbrook also re-affirmed the requirement in section 2(a)(51)(A)(ii) that at least *two or more* natural persons (or estates, organizations, or trusts established by or for the benefit of such persons) be beneficiaries of the trust. In Meadowbrook, five trusts were seeking to meet the requirements of a qualified purchaser. Four of the trusts had two or more beneficiaries meeting the family relationship requirement, as well as all the other requirements of section 2(a)(51)(A)(ii), and therefore met the requirements of a qualified purchaser under section 2(a)(51)(A)(ii). In the case of the fifth trust, the trust was established for a single beneficiary and therefore the petitioners believed the trust could not satisfy two or more requirements of section 2(a)(51)(A)(ii). As a result, the petitioners sought and received qualification for the fifth trust under section 2(a)(51)(A)(iii).

Trusts in Which the Trustee and Each Settlor Are Qualified Purchasers. Section 2(a)(51)(A)(iii) defines a trust as a qualified purchaser if (1) the trustee or other person authorized to make decisions for the trust *and* (2) each settlor or other person who has contributed assets to the trust is each a qualified purchaser. As the Staff stated in Meadowbrook, this section is premised on Congress's belief that certain persons, at the time of making the investment decision, should have the financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the 1940 Act. It is also premised on Congress's intent that the person whose assets are at risk be able to appreciate the risks presented by an investment pool that is not subject to regulation.

To determine who must be a qualified purchaser, the SEC looks at the trustee (or other authorized person, such as an investment advisor) that is responsible for making the investment decision and therefore responsible for assessing the risks associated with the investment. If the trust has more than one trustee, the SEC requires only that the entity responsible for making the investment decision be a qualified purchaser. See American Bar Association, SEC No-Action Letter, at § C, q.-1 (Apr. 22, 1999). If more than one trustee is responsible for the trust's investment decision, each trustee would need the required sophistication to evaluate the risks of the investment as a qualified purchaser. As such, each trustee's status would need to be considered.

The determination of whether a settlor is a qualified purchaser is made at the time he or she contributed assets to the trust. As demonstrated in Meadowbrook, the SEC takes the position that the settlor, or anyone who has contributed assets to the trust, would have to have been a qualified purchaser at least once when he or she contributed assets to the trust. If the settlor was a qualified purchaser when he or she initially funded the trust, the settlor would not need to be a qualified purchaser when he or she made later contributions. Conversely, if a settlor was not a qualified purchaser when he or she initially funded the trust but was a qualified purchaser at any time that he or she made a later contribution, the settlor would also meet the requirement.

In Meadowbrook, the Staff also answered the question of whether the qualified purchaser status of a deceased settlor needed to be considered. In Meadowbrook, the petitioner contended that the section 2(a)(51)(A)(iii) requirement that the settlor of the trust be a qualified purchaser should not apply when the settlor is deceased. The petitioner argued that, when the settlor has died before the trust's acquisition of securities, the deceased settlor's status should be irrelevant and the status of the trustees making the investment decisions should control the trust's qualified purchaser status. The Staff disagreed and stated that Congress expressly required that a settlor of a trust seeking qualification under section 2(a)(51)(A)(iii) (or other person who has contributed assets to the trust) be a qualified purchaser. Specifically, the Staff stated its belief that Congress intended that the settlor have the requisite degree of financial sophistication at the time the settlor contributed the assets to the trust.

In the case of very old trusts, the requirement that a deceased settlor must have been a qualified purchaser at the time the trust was funded, or at the time additional assets were contributed, can pose a challenge for trustees and their advisors. One way to determine whether a settlor that is long dead was a qualified purchaser is to consider whether the settlor, at the time he or she contributed assets to the trust, would have been worth $5 million or more in 1996 dollars (the date of the National Securities Markets Improvement Act of 1996 that added section 3(c)(7) and section 2(a)(51)(A)(iii)). Considering a deceased settlor's worth in 1996 dollars would appropriately identify a settlor that would have had the requisite financial sophistication to be considered a qualified purchaser at the time of his or her contribution to the trust. Even though such a settlor may not technically have been in possession of investments valued at $5 million at the time, the value of such investments may be adjusted by using the Consumer Price Index, which captures changes in value over time.

The foregoing approach was used by the petitioner in the Trusts Under the Will of Marion Searle, SEC No-Action Letter (Mar. 29, 2005) ("Searle"). The petitioner in Searle was seeking qualified purchaser status for several trusts that were funded on the death of Marion Searle in 1959. The petitioners were able to show that the settlor owned $3.215 million in investments in 1959 dollars. Adjusting this amount by using the Consumer Price Index, the petitioners were able then to show that the settlor exceeded by a significant margin the $5 million dollar qualified purchaser threshold.

Alternatively, a trust that was itself worth $5 million in 1996 could arguably be viewed as a proxy for the wealth of the settlor at the time the settlor contributed assets to the trust on the theory that, if a settlor contributed enough assets to the trust for the trust to be worth $5 million in 1996, then the settlor probably was worth at least $5 million (in 1996 dollars) at the time that the settlor contributed assets to the trust. The SEC, however, has not been presented with this situation and has not made this determination.

How Does a Revocable Trust Meet the Qualified Purchaser Requirements?

In determining whether a revocable trust is a qualified purchaser, sections 2(a)(51)(A)(ii) and 2(a)(51)(A)(iii) also apply. In meeting the requirement under section 2(a)(51)(A)(iii) that the settlor be a qualified purchaser, the Staff has stated that there may be other situations in which a settlor would have, at the appropriate time, the requisite financial sophistication to appreciate the risks presented by an unregistered investment, thereby satisfying the purpose of the requirement that the settlor be able to appreciate the risks presented by an investment pool that is not subject to regulation under the 1940 Act. Specifically, the Staff in Meadowbrook noted that situations in which the settlor has express authority to make the decision whether to invest, or has other rights in the operation of the trust, such as the right to revoke the trust or to change the trustees, and is a qualified purchaser, the settlor arguably could meet the qualified purchaser requirement.

Conclusion

Alternative investments represent a number of asset classes that can be appropriate for inclusion in trust portfolios. When access to these asset classes is best obtained through unregistered private investment vehicles, trustees and their advisors are well advised to understand the accredited investor and qualified purchaser rules to ensure that such investments do not run afoul of the 1933 Act or the 1940 Act. ■