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

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I. Uniform Prudent Investor Act

The Uniform Prudent Investor Act ("UPIA") reflects a "modern portfolio theory" and "total return" approach to the exercise of fiduciary investing. The UPIA removed much of the common law restrictions on the investment authority of fiduciaries and replaced the former Prudent Man Rule. As a result, a trustee's performance is measured by the investment performance of the entire portfolio. A trustee is now required to use modern portfolio theory and a sophisticated risk-return analysis to guide investment decisions. This has caused trustees to shift their focus to asset allocation and diversification in addition to security selection. Diversification plays a critical role in terms of reducing risk and volatility while maintaining or improving returns.

With the shift to modern portfolio theory under the UPIA, no category or type of investment is deemed inherently imprudent per se. In fact, an appropriate asset allocation and diversification strategy (one that maximizes return while minimizing risk and volatility) may include investments in derivatives, futures, commodities and other investments which may hedge investment risk. For most trustees, 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 in order to assess and advise whether a trust is legally permitted to make an investment in such an investment vehicle.

II. 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 addition, laws and regulations are in place to prevent deceit, misrepresentation and fraud in the sale of securities. While there are many laws that govern the securities industry, for purposes of our discussion, we will focus on the federal laws in this area, specifically on the *Securities Act of 1933* and the *Investment Company Act of 1940.*

1. <u>Securities Act of 1933</u>

The Securities Act of 1933 (the "1933 Act") regulates public offerings of securities. It prohibits offers and sales of securities which are not registered with the Securities and Exchange Commission (the "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 to publicly disclose significant information about themselves and the terms of the securities.

2. <u>Investment Company Act of 1940</u>

The Investment Company Act of 1940 (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 may 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 regularly update such information 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. However, both of these Acts provide various exemptions from registration for certain securities and certain issuers. In the case of the 1933 Act, Regulation D ("Reg. 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.***

III. 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 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 provide access to markets such as commodities, currencies, global bonds, real estate and private equity. Generally speaking, access to these types of asset classes are commonly offered through unregistered private investment vehicles.

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 vehicles is an understanding of whether a trust meets the requirements of an accredited investor and/or qualified purchaser.

IV. 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 who are "accredited investors." Pursuant to 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. Pursuant to Rule 501, an accredited investor is defined as any person who comes within eight categories set forth therein, or who the issuer reasonably believes comes within those categories, at the time the securities are sold.

The federal securities laws define the term accredited investor in Rule 501 of Regulation D as:

1. *Any bank as defined in section 3(a)(2) of the Act, or any savings and loan association or other institution as defined in section 3(a)(5)(A) of the Act whether acting in its individual or fiduciary capacity; any broker or dealer registered pursuant to section 15 of the Securities Exchange Act of 1934; any insurance company as defined in section 2(a)(13) of the Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; any Small Business Investment Company licensed by the U.S. Small Business Administration under section 301(c) or (d) of the Small Business Investment Act of 1958; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of $5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, as defined in section 3(21) of*

such act, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors;

2. *Any private business development company as defined in section 202(a)(22) of the Investment Advisers Act of 1940;*
3. *Any organization described in section 501(c)(3) of the Internal Revenue Code, corporation, Massachusetts or similar business trust, or partnership, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of $5,000,000;*
4. *Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;*
5. *Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;*
6. *Any natural person who had an individual income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year;*
7. *Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person as described in Rule 506(b)(2)(ii); and*
8. *Any entity in which all of the equity owners are accredited investors*.

The foregoing exceptions are aimed at identifying individuals and entities that have the requisite sophistication to invest in higher risk assets without the need for the information and disclosures an issuer must make in a 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. Rule 501 often uses net asset value as a proxy for determining sophistication. For example, an individual with a net worth in excess of $1 million or a trust with an asset value in excess of $5 million is deemed to be sophisticated enough to appreciate the risk of an unregistered securities offering.

1. <u>Irrevocable Trust</u>

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

A. 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) to be a purchaser who, 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.

B. Trusts Managed by a Bank or Investment Company

Alternatively, a trust of any size may be an accredited investor under Rule 501(a)(1) so long as a bank, insurance company, registered investment company, business development company, or small business investment company is serving as a trustee and/or has authority to make investment decisions on behalf of the trust. The SEC has determined that while 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 under Rule 501(a)(1).[i] The same is the case for a trust with a bank acting as co-trustee, so long as the bank is acting in its fiduciary capacity on behalf of the trust with respect to investment decisions and the trust follows the bank's direction.[ii]

2. <u>Revocable Trusts and other Trusts</u>

Similar to irrevocable trusts, revocable trusts can qualify as an accredited investor under Rule 501(a)(7) and 501(a)(1). In addition, Rule 501(a)(8) provides that an entity in which all of the equity owners are accredited investors is an accredited investor. However, in the case of an irrevocable trust, the trust beneficiaries are not considered to be 'equity owners' and it is not the case that if all of the trust beneficiaries are accredited investors the trust is an accredited investor. The result is different in the case of a revocable trust where the trust is established by the grantor(s), (often created to facilitate the distribution of an estate in the event of death), during the life of the grantor(s) the trust may be amended or revoked by the grantor(s) and all the tax benefits of investments made by the trust pass through to the grantor(s). In this case, the grantor(s) is considered the 'equity owner' and if each grantor is an accredited investor under Rule 501(a)(5) or Rule 501(a)(6) (i.e. they meet the net worth or income tests), the trust is an accredited investor.[iii]

Rule 501(a)(8) also provides the path for an individual retirement account ("IRA") to qualify as an accredited investor. In the case of an IRA, the participant is deemed to be the equity owner and if the participant is an accredited investor under Rule 501(a)(5) or Rule 501(a)(6), the IRA is deemed to be an accredited investor.

Finally, there are some limited instances where 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 where the (1) trust is a grantor trust for federal income tax purposes with the grantor as the sole funding source, (2) grantor is the trustee with sole investment discretion, (3) entire amount of the grantor's contribution plus a rate of return would be paid to the grantor prior to any other payments, and (4) 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.[iv]

V. Qualified Purchaser

Similar to the case where an issuer of securities may seek to avoid registration of their securities under the 1933 Act, an issuer may also seek to avoid registration 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, and hence exempt from registration as an investment company, if the securities offered by the issuer are owned exclusively by persons who are qualified purchasers. 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, however, a higher threshold for a qualified purchaser under the 1940 Act than for an accredited investor under the 1933 Act, but 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: (i) individuals with at least $5 million in investments; (ii) family-owned companies with at least $5 million in investments; (iii) certain trusts in which the trustee and each settlor are qualified purchasers, and; (iv) companies with at least $25 million in investments.

The federal securities laws define the term qualified purchaser in Section 2(a)(51)(A) of the 1940 Act as:

> *(i) any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) [15 USCS § 80a-3(c)(7)] with that person's qualified purchaser spouse) who owns not less than $5,000,000 in investments, as defined by the Commission;*
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> *(ii) any company that owns not less than $5,000,000 in investments and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (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;*
>
> *(iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or*

(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.

1. Irrevocable Trust

There are two primary means by which an irrevocable trust can meet the requirements of a qualified purchaser. The requirements of Section 2(a)(51)(A)(ii) and Section 2(a)(51)(A)(iii) can be applied to an irrevocable trust.

A. Family-owned Companies with at Least $5 Million in Investments

Section 2(a)(51)(A)(ii) provides that any company that owns not less than $5 million in investments and is owned directly or indirectly by 2 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 it is 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.[v] 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, shall not be 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 ("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 No-Action Letter (August 26, 1998) ("Meadowbrook") that it believed that Congress intended that all economic interests in a company that relies 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 spouse (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 re-affirmed the requirement in Section 2(a)(51)(A)(ii) that there be at least *two or more* natural persons (or estates, organizations or trusts established by or for the benefit of such persons) who are 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 that met 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 the two or more requirement 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).

B. 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 with respect to the trust and (2) each settlor or other person who has contributed assets to the trust, is each a qualified purchaser. This section is premised on Congress' 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.[vi] It is also premised on Congress' 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.[vii]

To determine who must be a qualified purchaser, the SEC looks at the trustee (or other authorized person such as an investment advisor) who 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 only requires that the entity responsible for making the investment decision be a qualified purchaser.[viii] If more than one trustee is responsible for the trust's investment decision, each such 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 assts to the trust.[ix] 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.[x] 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 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 in the instance where the settlor has died prior to 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 in Meadowbrook 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 they believed that Congress intended that the settlor have had 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 had to have been a qualified purchaser at the time the trust was funded or at the time additional assets were contributed to the trust may pose a real challenge for trustees and their advisors. One way to determine whether a settlor who is long deceased 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)).[xi] Considering a deceased settlor's worth in 1996 dollars would appropriately identify a settlor who 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 long periods of time.

The foregoing approach was used by the petitioner in the Trusts under the Will of Marion Searle No-Action Letter (March 29, 2005) ("Searle"). The petitioner in the Searle was seeking qualified purchaser status for several trusts that were funded upon the death of Marion Searle in 1959. The petitioners were able to show that the Settlor owned $3,215,000 in investments in 1959 dollars. Adjusting this amount by using the Consumer Price Index, the petitioners were then able 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.

2. <u>Revocable Trusts and Other Trusts</u>

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 settlor 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 noted that situations where the settlor has express authority to make the decision whether to invest, or has other rights with respect to 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 at that time.[xii]

With respect to whether an IRA is a qualified purchaser, the SEC looks through the IRA to its creator.[xiii] When an entity, such as an IRA, acquires securities issued by a Section 3(c)(7) Fund, the entity is considered the alter ego of the investor. The SEC would consider the acquisition to have been made by the investor.[xiv] Therefore, the investor must individually meet the requirements of a qualified purchaser under Section 2(a)(51)(A).

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[i] *See* Interpretive Release on Regulation D, Release No. 33-6455, at Question 26 (March 10, 1983).

[ii] *See* NEMO Capital Partners L.P., SEC No-Action Letter (April 11, 1987).

[iii] *See Lawrence B. Rabkin, Esq*. No-Action letter re Rule 501(a) (8) of Regulation D dated July 16, 1982.

[iv] *See* Division of Corporate Finance Compliance and Disclosure Interpretations Re: Securities Act Rules (last updated September 14, 2009) *citing* Herbert S. Wander No-Action Letter (November 25, 1983).

[v] *See* Meadowbrook Real Estate Fund, SEC No-Action Letter (August 26, 1998).

[vi] *See* Meadowbrook *supra* at Note 5.

[vii] *See id.*

[viii] *See* American Bar Association No-Action Letter, at Section C, Question 1 (April 22, 1999).

[ix] *See* Meadowbrook *supra* at note 5.

[x] *See id*.

[xi] *See* Trusts Under the Will of Marion Searle, No-Action Letter (March 29, 2005).

[xii] *See* Meadowbrook *supra* at note 5.

[xiii] *See* ABA Letter *supra* at note 8 at Section B, Question 2.

[xiv] *See id.*

Irrevocable Trust

Accredited Investor

Trust

Accredited Investor 501(a)(7)

Trust with total assets in excess of $5,000,000 not formed for the specific purpose of acquiring the securities offered whose purchase is directed by a *sophisticated person*

Sophisticated person(s) directing purchase

Sophisticated Person: A person who has such knowledge and experience in financial and business matters that he/she is capable of evaluating the merits and risks of the prospective investment

Accredited Investor 501(a)(1)

Trust with total assets of any amount

Bank, investment company, etc. is acting in a fiduciary capacity serving as sole trustee or co-trustee

Irrevocable Trust

Qualified Purchaser

Trust

Qualified Purchaser 2(a)(51)(A)(ii)

Trust with assets of $5,000,000 or more, with two (2) or more beneficiaries, and all of the beneficiaries are natural persons related as:

- Siblings
- Spouses (including former spouses)
- Direct lineal descendents by birth or adoption
- Spouses of such persons
- Estates of such persons
- Foundations, charitable organizations or trusts established by or for the benefit of such persons

Qualified Purchaser 2(a)(51)(A)(iii)

Trust with total assets of any amount

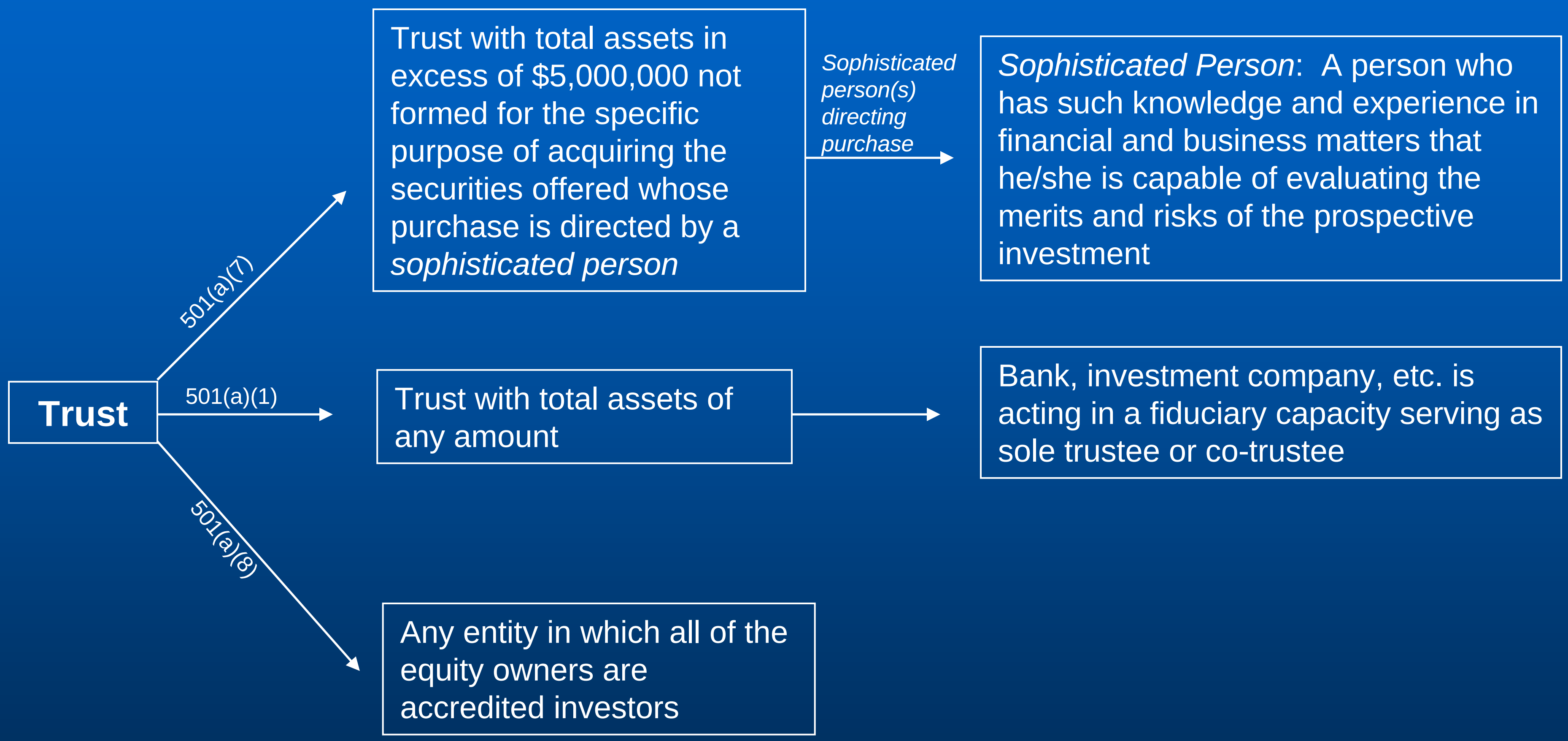
Trustee(s) or Investment Advisor involved in making the investment decision is a Qualified Purchaser

AND

Each settlor or other person who contributed assets to trust is/was a qualified purchaser at the time of contribution/funding

Revocable Trust

Accredited Investor



Revocable Trust

Qualified Purchaser

Trust

Qualified Purchaser 2(a)(51)(A)(ii)

Trust with assets of $5,000,000 or more, with two (2) or more beneficiaries, and all of the beneficiaries are natural persons related as:

- Siblings
- Spouses (including former spouses)
- Direct lineal descendents by birth or adoption
- Spouses of such persons
- Estates of such persons
- Foundations, charitable organizations or trusts established by or for the benefit of such persons

Qualified Purchaser 2(a)(51)(A)(iii)

Trust with total assets of any amount

Trustee(s) or Investment Advisor involved in making the investment decision is a Qualified Purchaser

AND

Each settlor or other person who contributed assets to trust is/was a qualified purchaser at the time of contribution/funding