

IDENTIFYING INVESTORS FOR PRIVATE INVESTMENT PRODUCTS

Investment Management Alert
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Investment managers need to identify those investors who will be qualified to invest in their private investment products must confront a complex web of investor classifications under the federal securities laws. This article will summarize the principal investor qualification requirements of four securities law regulatory regimes as an aid to answering a key question — who will be able to invest in a specific private investment product?

(1) The Securities Act of 1933 — Regulation D and “accredited investors.”

Private investments are typically sold to investors under the exemption from Securities Act registration provided by SEC regulation D. More specifically, private investment vehicles typically offer their securities exclusively to persons who meet the Regulation D definition of “accredited investor” because by doing so they are able to take advantage of reduced requirements under the rule both as to the written disclosure information that must be provided to all investors and as to the number of investors who may participate in the offering.

(2) The Investment Company Act of 1940 — Section 3(c)(7) exclusion and “qualified purchasers.”

Private investment companies are designed to take advantage of one of two exclusions from regulation under the Investment Company Act for issuers that do not make public offerings of their securities — Section 3(c)(1), which applies to issuers that are beneficially owned by not more than 100 persons, and Section 3(c)(7), which applies to issuers that are owned exclusively by persons who are “qualified purchasers.” Organizers of private investment companies seek to use one of the exclusions from the investment company definition in order to avoid the burdensome operating requirements that the Investment Company Act places on investment companies that are not otherwise excluded.

There are no special investor qualification requirements for Section 3(c)(1) private investment companies. Organizers of Section 3(c)(7) private investment companies generally choose that exemption when the 100 owners restriction of Section 3(c)(1) would unduly restrict their operations.

(3) The Investment Advisers Act of 1940 — Rule 205-3 and “qualified clients.”

Generally, Section 205(a)(1) under the Investment Advisers Act prohibits registered investment advisers from charging their clients performance fees — that is, fees

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IDENTIFYING INVESTORS FOR PRIVATE INVESTMENT PRODUCTS

based on a percentage of capital gains or capital appreciation of funds under management. SEC rule 205-3 provides that, notwithstanding the prohibition of Section 205(a)(1), a registered investment adviser may charge performance fees to those of their clients who meet the special qualifications of “qualified clients.”

Although investment advisers to private investment companies are not generally required to register under the Investment Advisers Act, some of them do so based on other concerns, such as having more than 15 clients outside of the fund, or in order to provide additional assurance and credibility to investors in their funds. Many, although not all, private investment companies charge performance fees. Those private investment companies that charge performance based fees and whose investment managers are registered investment advisers must limit their investors to those who qualify as qualified clients.

(4) The Commodities Futures Act — Section 4.7 and “qualified eligible purchasers.”

Private investment companies that invest in commodity futures and commodity options for which the aggregate initial margin and premiums exceed 10% of the fair market value of the fund’s assets typically seek to comply with Rule 4.7 of the Commodities Futures Trading Commission. Rule 4.7 provides significant disclosure and filing relief to commodity pool operators who manage commodity pools that meet its requirements. A key element of the exemption provided by Rule 4.7 is that the fund’s shares be offered and sold exclusively to persons who are “qualified eligible purchasers” in an offering that is exempt from registration under the Securities Act as a private placement.

Consider the Following Investment Classifications

The columns in the following chart identify the four classes of investor qualifications referred to above, and the rows in the chart show the application of the qualifications to the three principal types of investors that private investments are offered to — individuals, business entities (such as, corporations and partnerships), and trusts.

Accredited
Investors (1)

Qualified
Purchasers (2)

Qualified
Clients (3)

Qualified Eligible
Purchasers (4)

Individuals

Net worth - \$1 million (individually or with spouse)

OR

Income - 2 yr. past & current expected annual income of \$200K, or \$300K jointly with spouse Investments - any natural person who individually or jointly with spouse owns \$5 million of “investments” include securities (other than those of issuers with less than \$5 million of shareholder equity or that are controlled by the investor), real estate held for investment purposes, commodity interests and commodities held for investment purposes, and cash and cash equivalents held for

IDENTIFYING INVESTORS FOR PRIVATE INVESTMENT PRODUCTS

investment purposes. Managed Investments - natural person who has at least \$750K under the management of the investment adviser

OR

Net Worth - any person who has a net worth (individually or with spouse) of more than \$1.5 million

OR

Any Qualified Purchaser Accredited Investor requirements and, in addition,

Investments - Owns at least \$2 million of securities (including commodity pool participations) of unaffiliated issuers and other investments.

OR

Deposits - had on deposit with a futures commission merchant at any time during the preceding 6 months at least \$200K in exchange specified and initial margin and option premiums for commodity interest transactions

OR

Investments and Deposits -

The aggregate percentage attainment of the Investments standard and the percentage attainment of the Deposits standard equals at least 100%.

Business Entities Total assets in excess of \$5 million & not formed for the purpose of making the investment Investments -

Any person who owns and invests, in the aggregate, not less than \$25 million of “investments” on a discretionary basis.

OR

Investments - certain family owned companies if they were not formed for the purpose of acquiring the securities & own not less than \$5 million of “investments.” Managed Investments - any company that has at least \$750K under the management of the investment adviser.

OR

Net Worth - any company that has a net worth of more than \$1.5 million

OR

any Qualified Purchaser Total Assets - has \$5 million of total assets & was not formed for the purpose of investing in the pool.

Trusts Total assets in excess of \$5 million, not formed for the purpose of making the investment, & purchase directed by a

“sophisticated person.” Investments - Any trust not formed for the purpose of making the investment as to which the

trustees, settlors, and any person authorized to make decisions for the trust is a Qualified Purchaser Managed Investments - any company that has at least \$750K under the management of the investment adviser.

OR

Net Worth - any company that has a net worth of more than \$1.5 million

OR

any Qualified Purchaser Total Assets - has in excess of \$5 million of total assets, was not formed for the purpose of making the investment, & participation in the pool directed by a QEP

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Pending Changes — Note the following proposed changes to the "accredited investor" qualifications under Regulation D.

On December 27, 2006, the SEC proposed amendments to Regulation D that would have the effect of applying an enhanced accredited investor standard for any natural person who is investing in a private investment company that makes use of the 3(c)(1) exclusion from investment company registration. These persons, who would be defined as “accredited natural persons,” would have to meet either the existing \$1 million net worth test or the existing \$200,000 income test (see Chart) and a new \$2.5 million investments test.

On August 3, 2007, the SEC proposed another amendment to the accredited investor definition in Regulation D that would be generally applicable to individual investors. Under this proposed amendment, an additional and alternative accredited investor standard would qualify any individual who owned \$750,000 of investments (exclusive of the value of residences and places of business). For legal entities that would otherwise be required to satisfy a \$5 million assets test, the proposed amendment would add an alternative standard of \$5 million of investments.

Note that the foregoing discussion does not attempt to cover all of the ways in which investors may qualify under each of the defined classes. For example, the defined classes of investors typically provide for inclusion or special treatment for certain kinds of persons who are affiliates of the issuer of the private investment. These and other groups that may meet the special class requirements are not included because, except in special cases, they generally do not relate to the primary investor groups to which private investment products are marketed and because the exhaustive inclusion of all of the alternatives would require a discussion of a length and complexity that is beyond the scope of this presentation.

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