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REPORT

HEDGE FUNDS

Trusts as Hedge Fund Investors? — Accredited Investor and Qualified Purchaser Rules for Trusts and Other Estate Planning Vehicles

BY ANDREA LEVINE SANFT

Despite recent market conditions, hedge funds, private equity funds and similar alternative investments may continue to provide opportunities for fiduciaries seeking a well diversified portfolio.[1] Other authors have considered whether, under modern portfolio theory, such investments are appropriate for trusts and private foundations.[2] If a trustee or family entity

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[1] *See generally* Zachery Kouwe, *Hedge Fund Investors See Returns of 5 to 10%*, N.Y. Times, March 23, 2009, at B3. (The author suggests that despite significant losses at many funds, many investors believe that hedge funds will continue to post returns of 5 to 10 percent for 2009, exceeding the broader financial markets).

[2] *See e.g.*, Raymond C. Radigan, *What It Takes to be a Prudent Fiduciary – Especially in a Volatile Economy*, 347 PLI/Est 299 (2008); Michael J. Harrington, *Alternative Investments and Trust Investment Strategies* SH002 ALIABA 63 (2002);

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decides that an investment in a hedge fund or private equity fund is prudent, the next question is whether the trust (or entity) is a permissible investor. This article addresses that fundamental question: whether trusts, family entities and certain charitable organizations are permissible investors in a hedge fund, private equity fund or other private investment fund. To answer that question, the trusts and estates lawyer is in unfamiliar waters — securities law.

Private investment funds generally are funds which are exempt from registration under the Securities Act of 1933[3] and the Investment Company Act of 1940.[4] To fall within applicable exemptions, as a general matter, such private investment funds permit only those investors who are ''accredited investors'' (as defined in the 1933 Act) and ''qualified purchasers'' (as defined in the 1940 Act). Therefore, this article analyzes whether trusts, family entities and certain charitable entities may qualify as accredited investors and qualified purchasers.

I. *Securities Act of 1933*

Congress enacted the registration requirements of the Securities Act of 1933 to provide the public with information regarding potential investments so that they could make informed investment decisions and protect themselves in the marketplace.[5] Non-public offerings are exempt from the registration requirements.[6] The term ''non-public offering'' is not defined in the statute; however, Regulation D under the 1933 Act provides safe harbor rules for determining which offerings qualify as non-public.[7] Under Rule 506 of Regulation D, a sale of securities to an unlimited number of ''accredited investors'' and no more than thirty-five non-accredited investors will be deemed a non-public offering.[8] This exception to the registration requirements reflects Congress' assumption that accredited investors are sophisticated and able to protect their own financial interests without regulatory assistance.[9]

A. *Accredited Investors*

The term ''accredited investor'' is defined in Rule 501(a) of Regulation D. There are eight categories of accredited investors:

(1) a bank, savings and loan association or similar institution, as defined in Section 3(a)(5)(A) of the 1933 Act, acting in its individual or fiduciary capacity;

(2) private business development companies;

(3) any organization described in Internal Revenue Code Section 501(c)(3), corporation, partnership, or Massachusetts or similar business trust with total assets in excess of $5 million, which was not formed for the specific purpose of acquiring the securities offered;

(4) directors, executive officers or general partners of the issuer of the securities or any director, executive officer, or general partner of a general partner of that issuer;

(5) any natural person whose net worth (either alone or jointly with his or her spouse) at the time of purchase exceeds $1 million;

(6) a natural person who has an income in excess of $200,000 in each of the last two years or joint income with that person's spouse in excess of $300,000 in each of those years and reasonably expects to reach the same income level in the current year;

(7) any trust with total assets in excess of $5 million, which was not formed for the specific purpose of acquiring the securities offered, and whose purchase is directed by a sophisticated person; and

(8) entities in which all the equity owners are accredited investors under the foregoing categories.

B. *Trusts as Accredited Investors*

Within this framework, a trust may qualify as an accredited investor based on one of the following three characteristics: (i) the accredited investor status of an institutional trustee, (ii) the trust's qualification as an accredited investor, or (iii) in limited circumstances, the accredited investor status of the grantor.

1. *Institutional Trustees*

A trust with a bank or savings and loan association (or similar financial institution) as trustee will qualify as an accredited investor.[10] The term ''bank'' is defined as any national bank or any banking institution organized under the laws of any State, or the District of Columbia, the business of which is substantially confined to banking and which is supervised by the State or territorial banking commission or similar official.[11] In addition to savings and loan associations, Section 3(a)(5)(A) of the 1933 Act includes in the list of institutional accredited investors building and loan associations, cooperative banks, homestead associations and similar institutions which are supervised and examined by State or federal authority having supervision over such institution.[12]

(a) *Trust Companies*

It is not clear whether a trust company will qualify as a bank or similar institution for purposes of the accredited investor rules. Trust companies do not meet the definition of a bank under Section 3(a)(2) of the 1933 Act, nor are they similar to savings and loan associa-

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Douglas Moore and Mitchell K. Higgens, *Planning and Investing for Private Foundations*, 15 Tax'n of Exempts (Jan/Feb 2004) 156, at 163.

[3] Securities Act of 1933, 15 U.S.C.A. §§ 77a-77aa (1997 & Supp. 2008) (hereinafter the ''Securities Act of 1933'' or the ''1933 Act'').

[4] Investment Company Act of 1940, 15 U.S.C.A. §§ 80a-1-80a-64 (1997 & Supp. 2008) (hereinafter the ''Investment Company Act'' or the ''1940 Act'').

[5] *See,* H.R. Rep. No. 96-1341 (Sept. 17, 1980).

[6] Securities Act of 1933 § 4(2). (The statute exempts from registration ''transactions by an issuer not involving a public offering.'')

[7] 17 C.F.R. § § 230.501-230.508 (2008) (referred to hereafter by Rule number under Regulation D).

[8] Regulation D Rule 506. Any non-accredited investor must meet a certain level of sophistication set forth in the Regulation. The sophistication test requires that the investor have knowledge and experience in business matters or the assistance of a representative who has such knowledge and experience. If the issuer sells to any non-accredited investor, the issuer must make certain disclosures similar to those that would be necessary in connection with a public offering. *See* Regulation D Rule 502(b)(1). On the other hand, there is no disclosure necessary for sales to accredited investors only. *Id*. Therefore, many funds accept only accredited investors.

[9] H.R. Rep. No. 96-1341, *supra* note 5.

[10] Regulation D Rule 501(a)(1).

[11] Securities Act of 1933 § 3(a)(2).

[12] The SEC has taken the position that credit unions and United States branches of foreign banks are accredited investors. *See* Users Inc., SEC No-Action Letter, Fed. Sec. L. Rep. ¶ 78,966 (Mar. 1, 1989); U.S. Branches and Agencies of Foreign Banks, SEC No-Action Letter, 1989 WL 245457 (Jan. 4, 1989).

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tions under Section (3)(a)(5)(A) of the 1933 Act.[13] However, given the policy reasons for affording bank trustees accredited investor status, trust companies also should qualify as accredited investors. Banks (and similar institutions) are deemed accredited because they have substantial experience making sophisticated investment decisions such that the protections of registration under the 1933 Act are unnecessary.[14] There is no policy reason to distinguish between a traditional bank and a trust company (acting as fiduciary) for accredited investor purposes since trust companies also have significant investment experience.[15] In one No-Action letter, the SEC did not challenge the accredited investor status of a trust with a trust company as a co-trustee.[16] The issue in this No-Action letter was whether the accredited investor status of the trust company, as co-trustee, was sufficient under Rule 501(a)(1) if the other trustee was not accredited. The author of the inquiry took the position that the trust company was a bank under Section 3(a)(2) of the 1933 Act and the SEC did not address the issue.[17] While policy reasons support accredited investor status for trust company fiduciaries, the law remains unclear.

(b) *Fiduciary Capacity*

In order for a trust to qualify as an accredited investor under Rule 501(a)(1), the institutional trustee must be acting in its fiduciary capacity on behalf of the trust when purchasing the securities. In other words, the trust must acquire the securities based upon the investment decision of the institutional trustee.[18] As mentioned earlier, a trust will qualify as an accredited investor with a bank (or similar institution) as a co-trustee (along with an individual trustee who is not an accredited investor) so long as the bank controls the decisions regarding the purchase of securities.[19]

2. *Trusts With Assets Exceeding $5 Million*

A trust also may qualify as an accredited investor based on its own qualification under Rule 501(a)(7). Under this Rule, the trust (i) must have total assets in excess of $5 million, (ii) must not have been formed for the specific purpose of acquiring the securities offered, and (iii) must have a sophisticated person direct the trust's purchase of securities.[20]

(a) *Specific Purpose Exception*

Trusts formed for the specific purpose of acquiring the offered securities will not qualify as accredited investors. The specific purpose exception stems from the concern that non-accredited investors may try to qualify as accredited by pooling their assets into one entity.[21] While there is no published guidance on the specific purpose exception with respect to trusts, the SEC has set forth guidelines for a similar exception under Rule 501(e), which describes how to calculate the number of purchasers for certain limited sales of securities.[22] Under Rule 501(e)(2), an entity is treated as one purchaser unless it was formed for the specific purpose of acquiring the offered securities.[23] In one No-Action letter (interpreting the specific purpose exception under Rule 501(e)(2)), the SEC listed the following factors that are relevant in determining whether an entity was formed for the specific purpose of acquiring the securities: (i) the existence and nature of the entity's prior activities, (ii) 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[24] and (v) the extent to which all equity owners of the entity participate in investments by the entity.[25] For example, the SEC found that a partnership was formed for the specific purpose of acquiring the offered securities in a case where management was decentralized, since each partner could elect whether to participate in a particular investment or withdraw his or her investment.[26] In that event, the SEC took the position that the entity was created so that the individual partners could pool assets in order to qualify as accredited investors.[27]

With respect to the formation of a trust, factors to be considered include the time of the trust's creation, the percentage of the trust's assets invested in the securities and whether non-accredited grantors (if more than one) or trust beneficiaries can participate in decision making with respect to the investment. There are strong arguments to support a determination that a typical estate planning trust is not formed specifically for acquir-

[13] The business of a trust company is not substantially confined to banking within the meaning of Section (3)(a)(2) of the 1933 Act. *See* 9 C.J.S. Banks and Banking § 625 (2004).

[14] Securities Act Release No. 6758, 53 Fed. Reg. 7866 (March 3, 1988) (hereinafter ''Securities Act Release No. 6758'').

[15] As justification to expand the list of institutional investors to include savings and loan associations, the SEC stated that ''[m]ost of the states in their institutional investor exemptions already exempt securities offerings to these categories of investors,'' citing Section 402(b)(8) of the Uniform Securities Act, which includes trust companies in the list of exempt institutions. *Id*.

[16] Nemo Capital Partners, L.P., SEC NoAction Letter, Fed. Sec. L. Rep. ¶ 78,506 (April 11, 1987) (hereinafter ''Nemo'').

[17] *Id*. *But see* Franklin Trust Company, SEC No-Action Letter, 1984 WL 45877 (October 29, 1984) (hereinafter ''Franklin''). In Franklin, the SEC did not agree that the trust company was a ''bank'' under Section 3(a)(2) of the 1933 Act. *Id*. However, the issue in Franklin was whether Franklin could issue securities without registration and not whether the trust company was an accredited investor in its fiduciary capacity. *Id*.

[18] Nemo, *supra* note 16. *See also* Securities Act Release No. 6455, 1 Fed. Sec. L. Rep. (CCH) ¶ 2380 (March 3, 1983) (hereinafter ''Securities Act Release No. 6455'').

[19] Nemo, *supra* note 16.

[20] Regulation D Rule 501(a)(7).

[21] *See generally* Hall, Moneytree Associates Limited Partnership I, SEC No-Action Letter, 1983 WL 29899 (November 3, 1983) (analyzing the specific purpose exception under Rule 501(e)(2)) (hereinafter ''Hall, Moneytree''); Madison Partners, Ltd, SEC No-Action Letter 1982 WL 29842, (February 18, 1982) (hereinafter ''Madison Partners'') (a partnership was deemed to be formed for the specific purpose of acquiring securities since each partner could participate in investment decisions).

[22] Hall, Moneytree, *supra* note 21.

[23] Regulation D Rule 501(e)(2).

[24] The proposed Rules under Regulation D included a limitation on a trust's purchase to ten percent of its total assets. Securities Act Release No. 6683, 52 Fed. Reg. 3015 (Jan. 16, 1987) (hereinafter ''Securities Act Release No. 6683''). The Commission did not adopt the limitation, stating that ''general fiduciary principles and legal investment laws appear to be sufficient safeguards against concentration abuses which might arise.'' Securities Act Release No. 6758, *supra* note 14.

[25] Hall, Moneytree, *supra* note 21. *See* SEC Release No. 6683, *supra* note 24.

[26] SEC Release No. 6455, *supra* note 18 at Question 59, citing Madison Partners *supra* note 21.

[27] Madison Partners, *supra* note 21.

ing securities. The trust generally is formed by one individual (who often is an accredited investor) for the benefit of family members, with investment decisions controlled by a trustee. Under these circumstances, the opportunity for non-accredited investors to pool assets is not present.

(b) *Sophisticated Person*

The term ''sophisticated person'' is described in Rule 506(b)(2)(ii) as one who has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of the prospective investment.[28] In order to qualify under this rule, the issuer must ''reasonably believe'' that the offeree has the requisite level of sophistication.[29]

3. *Trusts With Accredited Investor Grantors*

In limited circumstances, a trust may qualify as an accredited investor based on the grantor's status as an accredited investor under Rule 501(a)(8) (entities in which all equity owners are accredited investors).[30] The SEC has determined that a revocable trust of which the grantor is an accredited investor will be deemed an accredited investor under Rule 501(a)(8) because the grantor, who could revoke the trust at any time, will be deemed the equity owner.[31] In addition, in one No-Action letter, the SEC determined that an irrevocable trust qualified as an accredited investor based on the grantor's status as an accredited investor under Rule 501(a)(8).[32] In this letter, the trust was a grantor retained annuity trust, or GRAT.[33] The characteristics of the trust that supported the SEC's determination included the fact that the trust was a grantor trust for federal income tax purposes, the grantor was the sole source of funding, the grantor was a co-trustee of the trust with sole investment discretion, the entire amount of the grantor's contribution to the trust plus a fixed rate of return was to be paid to the grantor or his estate before any payments would be made to the beneficiaries of the trust, the trust was established by the grantor for family estate planning purposes and the grantor's creditors could reach the grantor's interest in the trust at all times.[34] The SEC stated that, under these facts, the grantor was the equity owner of the trust and therefore, the trust was an accredited investor.[35]

The grantor's accredited status also was a factor in the SEC's favorable determination in a later No-Action Letter regarding an irrevocable trust.[36] The fact that the trust was a grantor trust for federal income tax purposes and that the grantor's creditors could reach the trust assets were characteristics that the SEC deemed critical under a Rule 501(a)(8) analysis. In addition, the SEC relied on other factors, such as the trust's assets of $3.5 million and the accredited investor status of the trustees.[37]

A trust cannot be accredited under Rule 501(a)(8) based solely on the status of its beneficiaries as accredited investors.[38] The beneficiaries are not considered the equity owners of the trust's assets for purposes of this Rule.

C. *Gifts and Resales*

While the focus of this article is whether a trust may invest directly in a private investment fund, many trusts acquire fund interests via gifts and intra-family sales to which the accredited investor rules may not apply. Registration under the 1933 Act is required for a sale or other disposition of a security for value.[39] The term ''sale'' is to be defined broadly and is intended to capture any method employed to obtain money from members of the public.[40] Gifts of securities will not trigger registration under the 1933 Act since gratuitous transfers do not fall within the definition of a sale under the Act.[41]

Intra-family sales also should be exempt from registration under Section 4(1) of the 1933 Act, which provides an exemption for transactions by any person other than an issuer, underwriter or dealer. Whether a particular resale of securities issued in a non-public offering falls within the exemption under Section 4(1) is a question of fact. Rule 144 of the 1933 Act offers a safe harbor under Section 4(1) for sales that meet certain criteria.[42] One requirement under Rule 144 is that the security be held for a minimum of one year prior to the sale.[43] Therefore, estate planning transfers that occur within one year of the original acquisition may not fall within the safe harbor. Such transfers nevertheless may be exempt under Section 4(1) so long as the transferor is not deemed to be an issuer, underwriter or dealer (as defined in Section 2 of the 1933 Act). The term underwriter is defined in Section (2)(11) of the 1933 Act to include any person who purchased the security from an issuer with a view to distribution. The term ''distribution'' refers generally to a public offering.[44] Therefore,

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[28] Regulation D Rule 506(b)(2)(ii).

[29] Regulation D Rule 506(b)(2)(ii). *See* Mark v. FSC Securities Corp., 870 F.2d 331 (6th Cir. 1989); Fisk v. Super Annuities Inc., 927 F. Supp. 718 (S.D.N.Y. 1996) (the court noted that the issuer may rely on the word of a prospective buyer as to his or her sophistication, assuming there is no alternative).

[30] Regulation D Rule 501(a)(8).

[31] *See* Securities Act Release No. 6455, *supra* note 18 at Question 30. *See also*, Lawrence B. Rabkin, Esq., SEC No-Action Letter, 1982 SEC No-Act, LEXIS 2690 (Aug. 16, 1982).

[32] Herbert S. Wander, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 3005 (Oct. 26, 1983) (hereinafter ''Wander'').

[33] I.R.C.§ 2702 (2002) and Treas. Reg. § 25.2702-3 (2008).

[34] Wander, *supra* note 32.

[35] *Id*. Whether the GRAT remainderman is accredited should not be relevant since the test for accredited investor status under Rule 501(a) is ''at the time of the sale'' of the security and not at the time of the subsequent distribution from the GRAT.

[36] Trans-Resources, Inc., SEC No-Action Letter, 1997 WL 280674 (May 27, 1997).

[37] *Id.* (Depending upon the facts, an irrevocable trust may qualify as accredited even though it does not meet all of the criteria set forth in *Wander*.)

[38] Securities Act Release No. 6455 *supra* note 18 at Question 26.

[39] Securities Act of 1933 § 2(a)(3).

[40] *See* Securities and Exchange Commission v. Addison, 194 F. Supp. 709, D.C. Tex. (June 2, 1961).

[41] *See generally* Securities Act of 1933 § 2(a)(3). However, if the transferee assumes the transferor's obligation to make further contributions to the company, for example, to meet future capital calls in an investment fund, the transferee must qualify as accredited at the time of such additional contributions.

[42] Securities Act of 1933 Rule 144. A comprehensive discussion regarding Rule 144 is beyond the scope of this article.

[43] *Id*.

[44] *See* C. Porter Vaughan III, *The Section ''4(1-1/2)'' Phenomenon; Private Resales of ''Restricted'' Securities; Report to the Committee on Federal Regulation of Securities from the Study Group on Section ''4(1-1/2)'' of the Subcommittee on the 1933 Act,* 34 Bus. Law. 1961 (1979); Rutherford B. Campbell, Jr., *Resales of Securities Under the Securities Act of 1933*, 52 Wash & Lee L. Rev. 1333 (1995).

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even if the resale occurs within one year of distribution, the seller in a private transaction should not be deemed an underwriter and the sale should be exempt under Section 4(1).

D. *Family Entities*

A corporation, partnership or limited liability company, or LLC, with total assets in excess of $5 million will qualify as an accredited investor so long as it was not formed for the purpose of acquiring the offered securities.[45] The SEC confirmed that, although Rule 501(a)(3) does not specifically refer to an LLC, an LLC may be treated as an ''accredited investor'' as defined in Rule 501(a)(3) if it satisfies the other requirements of that definition.[46]

In addition, a family entity will qualify as an accredited investor if all of the equity owners are accredited investors.[47]

E. *Charitable Entities as Accredited Investors*

Under Rule 501(a)(3) of Regulation D, any organization described in Section 501(c)(3) of the Internal Revenue Code, which was not formed for the specific purpose of acquiring the securities, will be an accredited investor so long as it has assets in excess of $5 million.[48] In addition, any charitable entity formed as a trust, which does not have assets exceeding $5 million, may still qualify as an accredited investor if it has a bank or similar institutional trustee that makes investment decisions on the trust's behalf.[49]

II. *Investment Company Act of 1940*

Similar to the 1933 Act, the Investment Company Act of 1940 was enacted to protect investors by providing information to the public regarding the investments of the issuing company.[50] Under the 1940 Act, certain entities, defined as ''investment companies,'' must register with the SEC and disclose information regarding their investment policies.[51] In addition to registration and annual reporting requirements, the 1940 Act imposes significant restrictions on the activities of registered investment companies and affiliated persons and provides for sanctions for violations of the Act.

As with the accredited investor exception under the 1933 Act, Section 3(c)(7) of the 1940 Act provides an important exception. Under this exception, companies that sell securities in a non-public offering exclusively to persons who are ''qualified purchasers'' are excluded from the definition of investment company and therefore, are not subject to regulation under the 1940 Act.[52] Unfortunately, while there are similarities, the definition of a qualified purchaser is not the same as that of an accredited investor.

A. *Qualified Purchasers*

The term qualified purchaser is defined in Section 2(a)(51) of the 1940 Act and includes:

(1) any natural person (and his or her spouse if they invest jointly) owning not less than $5 million in investments;[53]

(2) certain family-owned companies (including trusts) owning not less than $5 million in investments;

(3) a trust not described in the preceding clause (2) that is created by one or more qualified purchasers and for which investment decisions are made by qualified purchasers, so long as the trust is not established specifically for the purpose of acquiring the securities offered; and

(4) a person, acting for his own account or for the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis at least $25 million in investments.

As further described below, certain employees of the company, referred to as ''knowledgeable employees,'' and certain transferees also are deemed to be qualified purchasers.[54]

B. *Trusts as Qualified Purchasers*

A trust will be a qualified purchaser if it meets one of the following four requirements (or if the trust qualifies as a donee as discussed in paragraph 5 below): (i) the trust has at least $5 million in investments and is for the benefit of certain family members (described below); (ii) the trust's grantor and trustee are qualified purchasers; (iii) the trust owns or manages, for its own account or the accounts of other qualified purchasers, in the aggregate, at least $25 million in investments; or (iv) the

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[45] Regulation D Rule 501(a)(3). The SEC has stated that an entity's total assets include those assets that the investor may include on its balance sheet according to generally accepted accounting principles without regard to liabilities, including the assets of a subsidiary. Securities Act Release No. 6455, *supra* note 18, at Questions 5 and 19. It is not clear whether an unfunded capital commitment may be included in the entity's total assets for this purpose. (The qualified purchaser rules under the 1940 Act specifically include an unfunded commitment as an ''investment.'' *See* Investment Company Act Rule 2a51-1(b)(6)).

[46] Wolf, Block, Schorr and Solis-Cohen, SEC No-Action Letter, 1996 WL 714670 (Dec. 11, 1996).

[47] Regulation D Rule 501(a)(3).

[48] *Id*.

[49] Regulation D Rule 501(a)(1).

[50] *See* SEC Report on the Study of Investment Trusts and Investment Companies, H.R. No. 279 76th Cong., 1st Sess. (1940).

[51] Investment Company Act (Section 3(a)(1) of the 1940 Act defines an investment company generally as any company that (i) is engaged primarily in the business of investing, reinvesting and trading in securities or (ii) owns investment securities (defined in the statute) having a value exceeding forty percent of the value of the company's total assets.)

[52] Investment Company Act § § 2(a)(51) and 3(c)(7). These sections were added to the 1940 Act by the National Securities Markets Improvement Act of 1996. Pub. L. No. 104-290, 110 Stat. 3416 (Oct. 11, 1996).

[53] Generally, ''investments'' include: (1) securities; (2) real estate held for investment purposes; (3) commodity interests held for investment purposes; (4) physical commodities held for investment purposes; (5) financial contracts entered into for investment purposes; (6) for Qualified Purchaser Funds, 100 Person Funds or commodity pools seeking to be Qualified Purchasers, the amount of binding capital commitments to the fund (privately-offered employees' securities companies (under 1940 Act Section 6(b)) may also treat unfunded capital commitments as investments); and (7) cash and cash equivalents held for investment purposes. Investment Company Act Rule 2a51-1(b). In determining whether an individual is a qualified purchaser, individuals can include investments held jointly with their spouses, and spouses who are investing jointly in a qualified purchaser fund can each include any investments owned by the other spouse, even if those investments are not held jointly. Investment Company Act Rule 2a51-1(g)(2). To arrive at the total amount of a person's investments, the investments are reduced by the amount of any outstanding indebtedness incurred to acquire any such investment. Investment Company Act Rule 2a51-1(e). Investments can be valued based either on their fair market value or cost and must take into account indebtedness incurred to acquire an investment. Investment Company Act Rule 2a51-1(d).

[54] Investment Company Act Rule 3c-5 and Rule 3c-6.

trust's grantor and trustee are knowledgeable employees (defined below).[55]

1. *Family Trusts With $5 Million*

A trust will be a qualified purchaser if it owns at least $5 million in investments and was established by, or for the benefit of, two or more persons who are related as siblings or as a spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, estates of such persons and charitable organizations and trusts established by or for the benefit of such persons.[56] The staff has stated that individuals related as aunts, uncles, nieces and nephews will satisfy the familial relationship requirement.[57] The trustee need not be a family member.[58]

2. *Trusts With a Qualified Purchaser Grantor and Trustee*

If each of the grantor and the trustee of a trust is a qualified purchaser, the trust also will be a qualified purchaser so long as the trust was not formed for the specific purpose of acquiring the offered securities.[59] Similar to the requirements for trusts under the accredited investor rules, a trust may not qualify as a qualified purchaser solely based on the status of its beneficiaries as qualified purchasers.[60]

(a) *Qualified Purchaser Status of Grantor and Trustee*

Under this exception, a trust will be a qualified purchaser if both its grantor and trustee are qualified purchasers. The grantor's status as a qualified purchaser must be determined at the time that the grantor contributed assets to the trust.[61] If the grantor has made multiple contributions to the trust, the grantor must be a qualified purchaser only at the time of one such contribution.[62] If the grantor was not a qualified purchaser at the time of any contribution to the trust, there may be other factual circumstances that demonstrate that the grantor is a qualified purchaser for purposes of a particular investment.[63] For example, a grantor will be a qualified purchaser despite not having met the definition of qualified purchaser at the time the trust is created, if the grantor is a qualified purchaser at the time of the trust's purchase of securities and the grantor has explicit or implicit authority to determine if the investment in the qualified purchaser fund will be made.[64] The SEC also concluded that the grantor's status as a qualified purchaser is relevant even if the grantor is not living at the time of the trust's purchase of securities.[65]

The appropriate time to determine the qualified purchaser status of the trustee is when the trustee makes the decision to acquire the securities and not at the time that the trust is formed or when the trustee is appointed.[66]

(b) *Specific Purpose Exception*

As with the accredited investor rules under the 1933 Act, the requirement that the trust not be formed for the specific purpose of purchasing the securities is intended to limit the possibility that investors who are not qualified purchasers will pool their investments in an entity that satisfies the qualified purchaser test.[67] Similar to the analysis under the 1933 Act, whether a trust was formed for the specific purpose of acquiring the offered securities will depend upon the facts and circumstances.[68] The SEC has stated that, whereas the percentage of an entity's assets invested in the securities is relevant, exceeding a specified percentage level, by itself, is not determinative.[69]

3. *Trusts and Trustees Owning/Investing At Least $25 Million*

Any person, including a trust, acting for its own account, or the accounts of other qualified purchasers, who, in the aggregate, owns and invests, on a discretionary basis, at least $25 million in investments will be a qualified purchaser.[70] Any entity that seeks to qualify under this Section must not have been formed for the specific purpose of acquiring the securities (unless all of the beneficial owners of the entity are qualified purchasers).[71] This exception generally would apply to trusts with multiple owners who are not related (and therefore, do not qualify for the exception for family owned companies with $5 million in investments) and certain employee benefit plans with assets in excess of $25 million.[72]

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[55] Investment Company Act § 2(a)(51)(A) and Rule 3c-5.

[56] Investment Company Act § 2(a)(51)(A)(ii). Similar to the rule for individuals, the amount of investments of any family entity, including trusts, are reduced by the amount of any outstanding indebtedness incurred by the family entity or any owner of the family entity to acquire any such investment. Investment Company Act Rule 2a51-1(f).

[57] Meadowbrook Real Estate Fund, SEC No-Action Letter, 1998 WL 541510 (Aug. 26, 1998) (hereinafter ''Meadowbrook'') at n. 8. Unlike the accredited investor rules, it is not necessary that such a trust not be created for the specific purpose of acquiring the securities.

[58] American Bar Ass'n, SEC NoAction Letter, 1999 WL 235450 (April 22, 1999) (hereinafter ''ABA'') at Question 4; Meadowbrook *supra* note 57.

[59] Investment Company Act § 2(51)(A)(iii).

[60] ABA *supra* note 58 at Section C, Question 3. (The staff stated that ''We believe that Congress required that both the trustee and the settlor of the trust be qualified purchasers because of its belief that both the person contributing assets to the trust and the person authorized to make investment decisions with respect to those assets should have the requisite financial sophistication to understand and evaluate the risks associated with purchasing securities of an investment pool that is not regulated under the Investment Company Act.'')

[61] ABA *supra* note 58 at Section C, Question 1.

[62] Meadowbrook *supra* note 57 at n. 18.

[63] Meadowbrook *supra* note 57 at n. 21.

[64] *Id*.

[65] *Id*. In another No-Action letter, the grantor of numerous testamentary trusts was deceased at the time of the trustee's investment in a private investment fund. Trusts under the Will of Marion Searle, SEC No-Action Letter, 2005 WL 756472 (March 29, 2005). The SEC agreed that the value of the various trusts at the time that they were created could be aggregated and converted into 1996 dollars (the effective date of the legislation adding Sections 3(c)(7) and 2(a)(51)(A)(iii) to the 1940 Act) in order to determine whether the grantor had the requisite investments to meet the qualified purchaser test. *Id*.

[66] ABA *supra* note 58 at Section C, Question 1.

[67] Investment Company Act Release No. 22579, Fed. Sec. L. Rep. (CCH) ¶ 85,929 (April 3, 1997) at n. 112 and accompanying text.

[68] SCP Private Equity Partners II, LP No-Action Letter (June 6, 2006) (the trust was formed to acquire the securities for purposes of liquidating the company).

[69] ABA *supra* note 58 at Section D.

[70] Investment Company Act § 2(a)(51)(A)(iv).

[71] Investment Company Act Rule 2a51-3.

[72] *See e.g.*, The H.E.B. Investment and Retirement Plan, SEC No-Action Letter, 2001 WL 533465 (May 18, 2001); Heitman Capital Management, LLC, SEC No-Action Letter, 2007 WL 789073 (Feb. 12, 2007).

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In addition, a trustee may qualify under this Section if such trustee owns and/or invests, in the aggregate, at least $25 million.[73] However, a trust of which such person is trustee will not be a qualified purchaser solely based on the trustee's qualification.[74] In order for such trust to be a qualified purchaser, the trust's grantor also must be (or must have been) a qualified purchaser.[75]

4. *Knowledgeable Employee Exception*

Under Rule 3c-5 of the Investment Company Act, in determining whether the securities of a Section 3(c)(7) company are owned exclusively by qualified purchasers, any securities owned by knowledgeable employees may be excluded. A trust, which is not otherwise a qualified purchaser, may rely on the exception for knowledgeable employees, only if a knowledgeable employee is the source of the funds and a knowledgeable employee makes all of the decisions with respect to the trust's investments.[76] Knowledgeable employees include generally, executive officers, directors, trustees, general partners, advisory board members, or persons serving in a similar capacity of the company; or an employee of the company (other than an employee performing solely clerical, secretarial or administrative functions with regard to such company or its investments) who, in connection with his or her regular functions or duties, participates in the investment activities of the company, provided that such employee has been performing such functions and duties for or on behalf of the company for at least 12 months.[77] For example, a trust will be a qualified purchaser if an investment fund manager creates a trust and names another fund manager or employee (who falls within the knowledgeable employee definition) as trustee.[78]

5. *Transferees*

Certain transferees who receive securities from a qualified purchaser will be deemed to be qualified purchasers.[79] Pursuant to Rule 3c-6 of the 1940 Act, the following transferees are deemed to be qualified purchasers: (i) the estate of a qualified purchaser, (ii) donees of qualified purchasers and (iii) any company established by a qualified purchaser exclusively for the benefit of (or owned exclusively by) the transferor and one or more persons described in clauses (i) and (ii).[80] The term ''donee'' is defined as a person who acquires a security by gift, bequest or pursuant to an agreement relating to legal separation or divorce.[81] Any transferee who pays consideration for the securities is not a donee for this purpose.

At first blush, this rule would seem to indicate that any gratuitous transfer of a security will not trigger registration under the 1940 Act. However, the SEC has stated that the exception under Rule 3c-6 is not applicable in cases where the transferee is obligated to pay additional contributions to the company unless the transferor agrees to pay such additional contributions.[82] The SEC deems the transferee's obligation to provide such additional contribution as consideration for the transferred securities.[83] Therefore, for example, a transferee of an interest in an investment fund to which the transferee must make future capital contributions will not be a donee under this Rule and must qualify as a qualified purchaser in his, her or its own right.

C. *Family Entities as Qualified Purchasers*

A family partnership or limited liability company will be a qualified purchaser if the company (i) has at least $5 million in investments, and (ii) is owned by two or more individuals who are related as siblings, spouses, former spouses, or as 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.[84] If any person or entity other than those listed above owns an interest in the family partnership or LLC, the entity may, nevertheless, be a qualified purchaser if it owns and invests on a discretionary basis, not less than $25 million in investments.[85]

In addition, a partnership or LLC will be a qualified purchaser if all of the beneficial owners of the company's securities are qualified purchasers.[86]

D. *Charitable Entities as Qualified Purchasers*

A charitable entity organized as a trust will be a qualified purchaser if the grantor and the trustee of the trust are qualified purchasers and the trust was not formed for the specific purpose of acquiring the securities.[87] In addition, a charity with at least $25 million of investments will be a qualified purchaser regardless of its organizational structure.[88]

If a charity does not have at least $25 million in investments and is not a trust with a qualified purchaser as grantor and as trustee, the entity may nevertheless be a qualified purchaser if it owns at least $5 million in investments. Recall that, under Section 2(a)(51)(A)(ii) of the 1940 Act, a company that owns at least $5 million in investments will be a qualified purchaser if it is

[73] McDermott, Will & Emery, SEC No-Action Letter, 2007 WL 2318041 (July 26, 2007).

[74] Meadowbrook *supra* note 57.

[75] *See* Service Corporation, SEC No-Action Letter, 1998 WL 686251 (Oct. 6, 1998); Meadowbrook *supra* note 57 at n. 20. In that event, the trust would meet the qualified purchaser test under Section 2(a)(51)(A)(iii) of the 1940 Act for trusts with a qualified purchaser as grantor and as trustee, so long as the trust was not formed for the specific purpose of acquiring the securities.

[76] ABA *supra* note 58 Section A, Question 4.

[77] Investment Company Act Rule 3c5.

[78] It is not clear whether the knowledgeable employee who is the source of the funds also must be the trustee. A trust with a knowledgeable employee grantor and knowledgeable employee trustee (who is not the grantor) should satisfy the requirements under Rule 3c5.

[79] Investment Company Act Rule 3c-6.

[80] Investment Company Act Rule 3c-6(b).

[81] Investment Company Act Rule 3c-6(a)(1).

[82] ABA *supra* note 58 at Section E, Question 2. This is true even if the transferor provides the transferee with sufficient assets to pay the additional consideration. *Id*.

[83] *Id*.

[84] Investment Company Act § 2(a)(51)(A)(ii). Individuals related as aunts, uncles, nieces and nephews also will qualify as family members under this Section. *See* Meadowbrook, *supra* note 57.

[85] Investment Company Act § 2(a)(51)(A)(iv).

[86] Investment Company Act Rule 2a51-3. An entity may qualify under this rule irrespective of whether it was formed for the specific purpose of acquiring the offered securities. *Id*.

[87] Investment Company Act § 2(a)(51)(iii). In the case of a charitable entity, it is not likely that the trust would be formed for the specific purpose of acquiring the securities within the meaning of the 1940 Act (*i.e.*, to pool assets of non-qualified purchasers).

[88] Investment Company Act § 2(a)(51)(A)(iv).

owned by or for certain family members or entities, including charitable organizations created by such persons. Under this Section, a family company that has as one of its owners a charitable entity created by a family member will be a qualified purchaser.[89] However, it is not clear that a charity can, by itself, qualify under this Section since it is not owned ''by or for'' any particular person.[90] The beneficiaries of a charitable trust are charitable organizations or members of the general public, not family members.[91] Similarly, a charity organized as a corporation typically is a non-stock corporation without owners. Nevertheless, the SEC has stated that a charitable entity (whether formed as a trust or other entity) will be a qualified purchaser if (i) it was not formed for the specific purpose of acquiring the security, (ii) all of the persons who have contributed assets to the entity are related in one or more of the ways enumerated in Section 2(a)(51)(A)(ii), and (iii) it owns not less than $5 million in investments.[92]

III. *Comparison of Accredited Investor and Qualified PurchaserRules*

While the policies underlying the accredited investor exception under the 1933 Act and the qualified purchaser exception under the 1940 Act are similar, the two exceptions are not aligned. For example, an individual grantor or trustee may meet the income requirements for accredited investor purposes ($200,000 in each of the two most recent years, or $300,000 jointly with a spouse) but not the higher investment requirements ($5 million) for qualified purchasers. Similarly, an employee of the issuer may meet the definition of knowledgeable employee for qualified purchaser purposes but not qualify as a director, executive officer or general partner of the issuer (or its general partner) for accredited investor purposes.

If we combine the requirements for trusts as accredited investors and qualified purchasers, a trust with at least $5 million in assets, owned by or for certain family members, that has a sophisticated person as trustee will satisfy both the accredited investor and qualified purchaser requirements so long as it was not formed for the specific purpose of acquiring the securities. In addition, a trust with a bank trustee will qualify as an accredited investor and as a qualified purchaser if the bank owns or manages accounts with investments in excess of $25 million, the grantor is a qualified purchaser and the trust was not formed for the specific purpose of purchasing the securities.

A family entity will qualify as an accredited investor and qualified purchaser if (i) all of the owners of the entity qualify as both accredited investors and qualified purchasers or (ii) the entity has at least $5 million, was not formed for the specific purpose of purchasing the securities and is owned by or for the benefit of certain family members.

For quick reference, included at the end of this article is a chart that summarizes the requirements for accredited investor and qualified purchaser status with respect to trusts, family entities and charitable organizations.

[89] Investment Company Act § 2(a)(51)(A)(ii). *See* Goldman Sachs Asset Management, L.P., SEC No-Action Letter, 2007 WL 1027885 (March 13, 2007) (hereinafter ''Goldman Sachs'') at n. 8.

[90] Goldman Sachs *supra* note 89.

[91] In the case of a trust, the SEC has said that a trust is owned by its beneficiaries. ABA *supra* note 58, at Section C, Question 4.

[92] Goldman Sachs *supra* note 89.

	ACCREDITED INVESTOR	QUALIFIED PURCHASER
TRUSTS		
- Status of Trust	■ at least $5 million in total assets; ■ sophisticated person as trustee; and ■ not formed for the specific purposes of acquiring the securities	■ at least $5 million in investments; and ■ must be owned by or for certain family members
- Status of Grantor and/or Trustee	■ grantor of revocable (or, in limited circumstances) certain irrevocable trusts is an accredited investor;or■ bank trustee	■ grantor and trustee are qualified purchasers; and ■ not formed for specific purpose of acquiring securitiesor ■ knowledgeable employee as grantor and trustee; or■ owns or manages investment of at least $25 million
FAMILY PARTNERSHIPS AND LLCs	■ not formed for the specific purpose of acquiring the securities; and ■ at least $5,000,000 in total assets; or ■ all of the equity owners are accredited investors	■ at least $5 million in investments; and■ must be owned by or for certain family members; or ■ entity owns or manages investment of at least $25 million;or ■ all beneficial owners are qualified purchasers
CHARITABLE ENTITIES	■ 501(c)(3) organization; ■ not formed for the specific purpose of acquiring the securities; and■ at least $5 million in total assets;or ■ Trust with a bank trustee	■ 501(c)(3) organization; ■ at least $5 million in investments; ■ created by certain family members; and■ not formed for the specific purpose of acquiring the securities or ■ Trust with qualified purchaser grantors and trustees

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