Securities Law Considerations When Planning for Private Equity and Hedge Fund Managers

Determining Accredited Investor and Qualified Purchaser Status of Irrevocable Trusts

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The explosive growth in the private equity and hedge fund ("fund") industry over the past 20 years has created a wealthy class of individuals (that is, fund managers) with unique planning needs arising from the complex structure and economics of the funds they create and manage. As estate planners, we are well-versed in the transfer tax laws; however, we are rarely required to delve into the unfamiliar world of securities laws. To effectively plan for a fund manager, however, an understanding of such securities laws is crucial.

This article is intended to introduce the estate planner to some basic provisions of the securities laws applicable to the ownership of fund interests by irrevocable trusts created by a fund manager, with a particular focus on the qualification of such trusts as "accredited investors" and "qualified purchasers." When planning for a fund manager, however, it is imperative that the securities laws be thoroughly analyzed.

Why Do Estate Planners Need to Care About the Securities Laws?

Unless an exemption is available, the Securities Act of 1933 (the "1933 Act") and the Investment Company Act of 1940 (the "1940 Act") require a fund seeking to offer its interests for sale to register with the SEC and disclose specified information about the offering and the fund itself. These registration and disclosure requirements are intended to protect fund investors by providing sufficient information to allow such investors to evaluate the risks associated with the investment and make an informed decision whether to invest.

A fund can avoid the costly and time-consuming requirements associated with registration by limiting its investors to certain individuals and entities that are deemed to have the necessary financial sophistication, financial strength, and investment experience to fully understand and evaluate the risks associated with investing in the fund without the need for the disclosures that are required for offerings to the general public. Such individuals and entities are referred to as "accredited investors" (for purposes of avoiding registration under the 1933 Act) and "qualified purchasers" (for purposes of avoiding registration under the 1940 Act).

Most funds desire to avoid registration and, therefore, will admit only investors who are accredited investors and qualified purchasers. Accordingly, when transferring a portion of a fund manager's interests in a fund to an irrevocable trust, a careful analysis must be undertaken to ensure that the trust is an accredited investor and a qualified purchaser.

Overview of the Accredited Investor Rules and Qualified Purchaser Rules

Do the Registration Requirements Apply?

As a threshold issue, it first must be determined whether the registration requirements under the 1933 Act and 1940 Act are even applicable to the particular transaction. Although a fund manager will sometimes create an irrevocable trust to be a ground floor investor in a fund, it is more common for a fund manager to invest directly and then gift a portion of his fund interests to an irrevocable trust shortly after the fund's inception.

Gift Exception Under the 1933 Act. The registration requirements of the 1933 Act are generally applicable only to transfers of an interest in a fund in exchange for value. Thus, generally, an irrevocable trust receiving a portion of a fund manager's interests in a fund via a bona fide gift will not need to qualify as an accredited investor, subject to possible exceptions depending on the circumstances. For example, when a fund manager gifts a portion of his or her fund interests to an irrevocable trust, the trust will often be obligated to fulfill future capital calls made by the fund, and this capital call obligation could arguably undermine the "gift" characterization of the transaction.

Donee Exception Under the 1940 Act. Under the 1940 Act, an irrevocable trust receiving a fund interest from a fund manager by gift generally is not required to independently meet the criteria of a qualified purchaser. Rather, the qualified purchaser status of the fund manager will be imputed to the trust. This exception, however, does not apply if the trust exchanges consideration for the fund interests. Thus, if the trust is obligated to satisfy future capital calls, the trust will need to independently qualify as a qualified purchaser.

Accordingly, it is generally prudent to proceed on the assumption that any trust receiving a fund interest from a fund manager will need to qualify as an accredited investor and a qualified purchaser.

Irrevocable Trusts as Accredited Investors

The term "accredited investor" is defined in Rule 501(a) of Regulation D. Rule 501(a) sets forth eight categories of individuals and entities that qualify as accredited investors. Under these provisions, an irrevocable trust created by a fund manager can qualify as an accredited investor in one of the following ways.

Irrevocable Trusts with a Bank (or Trust Company) as a Trustee. Any irrevocable trust created by a fund manager will be treated as an accredited investor if the trust agreement designates a bank to serve as trustee of the trust. For purposes of the 1933 Act, 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. Rule 501(a)(1) of Regulation D treats banks as accredited investors. As discussed above, the accredited investor definition seeks to identify those investors who do not require the protections afforded by registration because of the investor's financial sophistication and investment experience. Banks are deemed to have the necessary level of financial sophistication, financial strength, and investment experience, and, therefore, if a bank is responsible for making investment decisions on a trust's behalf, the trust itself is deemed to have the required level of financial sophistication and investment experience. Thus, when a bank serves as a trustee of a trust and the trustee has the authority to make investment decisions on the trust's behalf, the bank's accredited investor status is imputed to the trust. The law is currently unclear on whether the Rule 501(a)(1) definition applies to a trust with a trust company, rather than a bank, as trustee. A trust company does not fall within the literal language of Rule 501(a)(1). But, based on the rationale underlying the banks' automatic accredited investor status, policy reasons appear to support a position that trust companies are within the definition because they generally have financial sophistication and investment experience comparable to that of a bank. On the other hand, the SEC generally reads the language of Rule 501 literally, and trust companies are not addressed in the rule. The SEC is currently considering revisions to Rule 501, and it would not be surprising to see trust companies included in the definition in a revised rule.

Irrevocable Trusts with Assets in Excess of $5 Million. If a fund manager prefers not to have a bank serve as trustee with authority to make investment decisions on behalf of a trust, the trust may nevertheless qualify as an accredited investor under Rule 501(a)(7) of Regulation D if each of the following requirements is met:

1. the trust owns assets having a value in excess of $5 million;
2. a "sophisticated person" directs the trust's investments; and
3. the trust was not formed for the specific purpose of investing in the fund.

Sophisticated Person Requirement. Under Rule 506(b)(2)(ii), a "sophisticated person" is any person who has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of a prospective investment. Generally, the trustee is responsible for directing a trust's investments, and, therefore, it is the trustee's status as a sophisticated person that must be evaluated. But, if someone other than the trustee, such as an investment advisor, is responsible for directing the trust's investments, it is such other person's status as a sophisticated person that must be evaluated.

Specific Purpose Limitation. If a trust is formed for the specific purpose of investing in a fund, the trust cannot qualify under Rule 501(a)(7), even if the trust's investments exceed $5 million and are directed by a sophisticated person. The purpose of this limitation is to prevent a group of non-accredited investors from qualifying as an accredited investor merely by pooling their assets together in an investment entity. Currently, there is no guidance for determining whether a trust has been formed for the specific purpose of investing in a fund. In interpreting Rule 501(e)(2), however, which contains the same "not formed for the specific purpose" requirement as Rule 501(a)(7), the SEC staff has stated that the following factors shall be taken into consideration in determining whether an entity has been formed for the specific purpose of investing in a security: (1) the existence and nature of the entity's prior activities; (2) whether the entity has centralized management and decision making; (3) the proposed activities of the entity; (4) the relationship between the entity's investment in the offering and the entity's capitalization; and (5) the extent to which all equity owners of the entity participate in investments by the entity. As a general matter, the specific purpose limitation should not apply to a typical irrevocable trust created by a fund manager. Most trusts are created by fund managers for legitimate estate planning purposes, often long before the fund manager transfers a portion of his fund interests to the trust. As a result, the trust should be deemed to have a specific purpose other than investing in the fund.

Irrevocable Trusts with Accredited Investor Grantor. A trust created by a fund manager also can be treated as an accredited investor under Rule 501(a)(8) of Regulation D if the fund manager is an accredited investor and each of the following requirements is met:

1. the trust is a grantor trust with respect to the fund manager for federal income tax purposes;
2. the fund manager is the sole source of funding;
3. the fund manager is the trustee and has sole investment discretion;
4. the entire amount of the fund manager's contribution to the trust plus a rate of return will be paid to the fund manager before any other payments; and
5. the assets of the trust are subject to the claims of the fund manager's creditors in the event of bankruptcy.

Herbert S. Wander, SEC No-Action Letter, 1983 SEC No-Act. LEXIS 3005 (Oct. 26, 1983).

A common trust used in estate planning that may satisfy each of these requirements is a grantor retained annuity trust.

Irrevocable Trusts as Qualified Purchasers

The term "qualified purchaser" is defined in section 2(a)(51)(A) of the 1940 Act, which sets forth four categories of qualifying individuals and entities. Under these provisions, an irrevocable trust created by a fund manager may qualify as a qualified purchaser in one of the following ways.

Irrevocable Trust with at Least $5 Million in Investments with Only Family Member Beneficiaries. A trust created by a fund manager with at least $5 million in investments will be treated as a qualified purchaser under section 2(a)(51)(A)(ii) of the 1940 Act, irrespective of whether such trust was created for the specific purpose of acquiring the fund manager's interests in the fund, if the trust has at least two beneficiaries and all beneficiaries share the appropriate familial relationship. For such a trust to be treated as a qualified purchaser under this exemption, all beneficiaries of the trust must be related as siblings or spouses (including former spouses), direct lineal descendants by birth or adoption, or spouses of such persons, aunts, uncles, nieces, and nephews ("family members"). If even one beneficiary of the trust (whether such beneficiary's interest is present or future, vested or contingent) does not share the appropriate familial relationship, the trust cannot qualify under section 2(a)(51)(A)(ii) of the 1940 Act. Most trusts created by a fund manager are created for the sole benefit of the fund manager's descendants. Therefore, more often than not, a trust created by a fund manager will qualify as a qualified purchaser under this section as long as the trust owns at least $5 million in investments.

Irrevocable Trust of Which Grantor and Trustee (or Investment Advisor) Are Qualified Purchasers. If a trust has at least one nonfamily member as a beneficiary, the trust may still qualify as a qualified purchaser under section 2(a)(51)(A)(iii) of the 1940 Act if both the grantor (in this case the fund manager) and the trustee (or other person responsible for directing the trust's investments, such as an investment advisor) are qualified purchasers, irrespective of the value of the trust's investments, provided that such trust was not created for the specific purpose of acquiring the fund manager's interests in the fund.

The fund manager must be a qualified purchaser at the time he contributes assets to the trust. A fund manager will qualify as a qualified purchaser if he owns at least $5 million in investments. The trustee (or investment advisor) must be a qualified purchaser at the time the trust acquires the fund manager's fund interests. An individual trustee may qualify as a qualified purchaser if he owns at least $5 million in investments and a bank or trust company trustee may qualify as a qualified purchaser if such bank or trust company owns and invests more than $25 million for its own account or the accounts of other qualified purchasers. If there are multiple trustees, only the trustees with investment authority must be qualified purchasers.

The determination of whether a trust was created for the specific purpose of acquiring the fund manager's fund interests requires an analysis of all surrounding facts and circumstances and is similar to the analysis applicable in the accredited investor context, discussed above.

Irrevocable Trust with Investments of at Least $25 million. An irrevocable trust created by a fund manager also can be a qualified purchaser under section 2(a)(51)(A)(iv) of the 1940 Act if the trust owns at least $25 million in investments, provided the trust was not created for the specific purposes of acquiring the fund manager's fund interests. The "specific purpose" requirement does not apply if all trust beneficiaries are family members (as defined above), in which case the trust would qualify as a qualified purchaser under section 2(a)(51)(A)(ii) of the 1940 Act.

Conclusion

A working knowledge of basic securities laws is essential for any estate planner advising fund manager clients. Generally, any trust created by a fund manager to which the fund manager intends to transfer a portion of his fund interests must qualify as both an accredited investor and a qualified purchaser. Although the purpose underlying the registration requirements of the 1933 Act and the 1940 Act are similar, the requirements that must be met for a trust to qualify as an accredited investor and a qualified purchaser differ, thus making it necessary to carefully analyze every trust under both sets of regimes. n