

U.S. Securities Laws Overview: Making Sense of “Accredited Investors,” “Qualified Purchasers,” and “Qualified Clients”

There are four major Acts of the U.S. Congress that, together with the regulations and rules promulgated pursuant to such Acts, form a perilous maze of securities laws applicable to venture capital funds and private equity funds. Fortunately, there are safe passages through such maze, and Morgan Lewis has the relevant experience in forming venture capital funds and private equity funds to know the way. The four major Acts of the U.S. Congress are the U.S. Securities Act of 1933, as amended (the Securities Act), the U.S. Securities Exchange Act of 1934, as amended (the Exchange Act), the U.S. Investment Company Act of 1940, as amended (the Investment Company Act), and the U.S. Investment Advisers Act of 1940, as amended (the Advisers Act).

A consistent theme throughout the U.S. securities laws is fraud prevention. As such, the first section below is an introductory paragraph regarding antifraud. This article then provides high-level summaries of the relevant provisions—i.e., relevant to venture capital funds and private equity funds—of each of the four Acts noted above. There are many other areas of securities laws, such as state securities laws (a.k.a. Blue-Sky laws) and non-U.S. securities laws, that are beyond the scope of this article.

Antifraud Provisions

Before jumping into the summaries of the four major Acts, it is important to note that all of such Acts, as well as the common law pertaining to securities, provide generally applicable antifraud provisions. Perhaps the best example of such antifraud provisions is Rule 10b-5 under the Exchange Act, which states in part: “It shall be unlawful for any person . . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”

To prevent fraud is arguably the prime directive of the U.S. securities laws. For this reason, most of the antifraud provisions of the U.S. securities laws apply to all issuers of securities, whether or not such issuers are otherwise required to register under any of the applicable Acts and whether or not provisions of such Acts other than the antifraud provisions apply to such issuers. Fund

managers should be mindful of potential fraud claims, even constructive fraud claims based on negligence, during every phase of forming and operating their funds. Morgan Lewis counsel can provide advice regarding appropriate disclosures to provide to fund investors, representations to obtain from fund investors, and other steps to take to avoid running afoul of the securities laws' antifraud provisions.

The Securities Act and “Accredited Investors”

Absent an exemption, all offers and sales of securities must be registered with the Securities and Exchange Commission (SEC) under the Securities Act. Because venture capital funds and private equity funds are offering and selling securities when they seek and accept investors into their funds, such offers and sales must be registered with the SEC, unless an exemption is available. Generally, fund managers do not want to register the offers and sales of interests in their funds. Registration is avoided primarily because of the costs, the public disclosure obligations, and the ongoing compliance obligations that flow from registration. Fortunately, there are a number of exemptions available to venture capital funds and private equity funds such that they need not register the offer or sale of their interests under the Securities Act.

Private Placements Under Regulation D

By far the most common exemption relied upon to avoid registration under the Securities Act is the private placement exemption. Under Section 4(2) of the Securities Act, the obligation to register the offer and sale of securities does not apply to transactions by an issuer not involving a public offering. This simple concept—the private placement—has mushroomed into an entire body of law unto itself. Case after case has made its way through courts as a result of uncertainty with respect to what is meant by “not involving a public offering.” These cases created so many pitfalls with respect to the private placement concept that the SEC ultimately adopted Regulation D under the Securities Act to provide guidance as to what would constitute a private placement. Regulation D has varying criteria for exemption depending on the size of the offering.

Rule 506 of Regulation D under the Securities Act seems to fit best for most fund offerings because there is no limit on the dollar amount that may be raised under Rule 506. To have a valid private placement under Rule 506, (i) investors must be “accredited investors” as defined in Regulation D and (ii) neither the fund nor any person acting on behalf of the fund may offer or sell interests in the fund by any form of general solicitation or general advertising.¹ General solicitation and general advertising include, but are not limited to, any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar media; or broadcast over television, radio, or the Internet (or other communications devices); and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

1. Rule 501 of Regulation D defines “accredited investors” as, generally, (A) individuals with net worth of at least \$1 million or annual income of at least \$200,000 and (B) entities with total assets of at least \$5 million. Married couples may aggregate their wealth and income for purposes of the net worth test and the income test, provided that the income requirement is increased to \$300,000 per year if relying on the joint income of a married couple.

Offshore Offerings Under Regulation S

Funds raising money outside the United States often rely on Regulation S under the Securities Act for their exemption from the registration requirements of the Securities Act. Regulation S uses a territorial approach for offers and sales of securities pursuant to which the registration requirements of the Securities Act apply to persons in the United States, regardless of citizenship, but do not apply to persons residing outside the United States. Under Regulation S, funds may engage in any offers and sales of securities to any persons for any amounts without violating the registration requirements of the Securities Act, provided that the requirements of Regulation S are met.

Note, however, that the securities laws of applicable non-U.S. jurisdictions, which are beyond the scope of this article, must be complied with. Although Regulation S provides a complex hierarchy of offering types and the corresponding requirements for each, the basic principle is that there must be no “directed selling efforts” in (toward) the United States. “Directed selling efforts” include any activity undertaken for the purpose of, or that could reasonably be expected to have the effect of, conditioning the market in the United States for any of the securities being offered in reliance on Regulation S.

With respect to funds that are raising money both in the United States and outside of the United States, the prudent course of action is to conduct the entire fund raising, regardless of jurisdiction, in a manner that satisfies the private placement requirements of Rule 506 (discussed above). If, for some reason, a fund manager desires to make offers and sales of securities outside the United States in a manner that would jeopardize the validity of the Rule 506 offering, the offering and sale of securities in the United States may be done pursuant to Rule 506, while the offering and sale of securities outside the United States is done pursuant to Regulation S—i.e., Rule 506 and Regulation S may be used simultaneously, provided strict compliance with both in their respective jurisdictions.

This discussion of the Securities Act provides a purposefully truncated summary and omits a large number of rules and exceptions because a full analysis of the Securities Act is beyond the scope of this article.

The Exchange Act

Issuer Exemption from Broker-Dealer Registration

Any person selling interests in the fund may need to register with the SEC under the Exchange Act as a broker-dealer. This would be a problem if it were not for an exemption provided for “associated persons” of an issuer. Without the exemption for associated persons of an issuer, each person within a fund that engages in any activity in connection with fund raising would need to register as a broker-dealer. The exemption, however, provides that natural persons who are directors, officers, partners, or employees of a fund or its general partner or other entity that controls, is controlled by, or is under common control with the fund do not need to register as broker-dealers as long as certain conditions are met. The most significant of such conditions are that the associated person cannot be compensated on the basis of any transactions in securities

and that such person has not engaged in any transactions of securities in the preceding 12 months.

Investor Limits to Avoid Public Filing Requirements

Another challenge that may present an issue for a venture capital fund or private equity fund under the Exchange Act is the requirement that any U.S. issuer (for our purposes, any U.S. fund) that has more than 499 holders of record or any non-U.S. issuer (non-U.S. fund) that has more than 299 holders of record resident in the United States comply with public disclosure, reporting, and other obligations as a public company under the Exchange Act. As a result, great care is taken to ensure that these limits are not exceeded. Caution is particularly warranted in master-feeder structures and parallel fund structures, as the facts and circumstances may require consolidating the investor count (such determinations are made on a case-by-case basis in consultation with your Morgan Lewis attorney).

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The Investment Company Act and “Qualified Purchasers”

It sometimes surprises people that venture capital funds and private equity funds are not investment companies, at least not as far as the Investment Company Act is concerned and provided that such funds have been formed in a manner that satisfies the definitional exclusions of Section 3(c) of the Investment Company Act. This is a good thing because investment companies must register with the SEC, which involves up-front and ongoing expenses, public disclosures, and increased regulatory compliance obligations, such as requirements for independent directors, prohibitions of affiliated transactions, and a labyrinth of other conflicts of interests rules. Generally, any issuer that is or holds itself out as being primarily engaged in the business of investing, reinvesting, or trading in securities is an investment company under the Investment Company Act. Clearly, venture capital funds and private equity funds would fall into this category, but the Investment Company Act provides a number of exclusions to what it defines as an investment company. The two exclusions that venture capital funds and private equity funds most often rely upon are Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act (funds relying on Section 3(c)(1) or 3(c)(7) are collectively referred to as “Excluded Investment Companies”).

Funds with No More Than 100 Investors

Section 3(c)(1) of the Investment Company Act excludes from being an investment company any issuer whose outstanding securities are beneficially owned by not more than 100 persons and that is not making and does not presently propose to make a public offering of its securities. The benefit of Section 3(c)(1) is that there is no additional status requirement for the investor, such as net worth, total assets, or total investments owned (although the “accredited investor” requirement described above under the Securities Act discussion would continue to apply). Section 3(c)(1) is deceiving in its faux simplicity. In fact, counting how many beneficial owners a fund has can be quite complicated. There are rules that require looking through certain entities

that invest in funds and counting their investors as part of the total number of the fund's investors. Three common situations in which this occurs are (i) the investor in the fund is itself an Excluded Investment Company and has acquired more than 10% of the fund's voting securities, (ii) the investor in the fund was formed for the purpose of investing in the fund (generally, a presumption exists that an investor was formed for the purpose of investing in the fund if 40% or more of the investor's assets are committed to the fund), and (iii) the investor in the fund permits its underlying investors to have discretion over whether or not they participate in the investor's participation in the fund.

Funds Owned Exclusively by Qualified Purchasers

Section 3(c)(7) of the Investment Company Act excludes from being an investment company any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of the acquisition of such securities, are qualified purchasers, and which is not making and does not at that time propose to make a public offering of such securities. The benefit of Section 3(c)(7) is that there is no limit to the number of investors the fund may have (subject to the limit imposed by the Exchange Act, discussed above). The difficulty with Section 3(c)(7) is that all of the investors must be "qualified purchasers." "Qualified purchasers" are investors that meet certain requirements regarding the total amount of investments owned—generally, institutions with \$25 million in investments and individuals or family companies with \$5 million in investments. Determining "qualified purchaser" status and calculating the amount of "investments" held by a prospective investor require close analyses of the investor's particular circumstances.

Knowledgeable Employees

Whether relying on Section 3(c)(1) or Section 3(c)(7), fund managers should note that "knowledgeable employees" (as defined in Rule 3c-5 under the Investment Company Act) may own securities of a fund that relies on Section 3(c)(1) or Section 3(c)(7), even if doing so would result in more than 100 persons beneficially owning the fund's securities and even though such employees are not qualified purchasers. This is possible, even in the face of the basic requirements of Sections 3(c)(1) and 3(c)(7), because the SEC has adopted a rule clarifying that "knowledgeable employees" are not counted for purposes of satisfying such exclusions. The term "knowledgeable employee" covers natural persons who are general partners, advisory board members, executive officers, and directors (or those having similar capacities), and any employee who for at least the prior 12 months, in connection with his regular functions or duties, participates in the investment activities of the fund or entities managed by the same manager as the fund.

Offshore Funds

With respect to funds that are formed outside of the United States and do not target any U.S. investors, the Investment Company Act has no jurisdiction. Caution is warranted, however, because if any U.S. investors are targeted, then the Investment Company Act does have jurisdiction. Section 7(d) of the Investment Company Act prohibits an offshore fund from publicly offering its shares in the United States unless, pursuant to an order from the SEC, the fund registers as an investment company under the Investment Company Act. Under SEC interpretations, however, an offshore fund may make private placements of its securities in the

United States without violating Section 7(d) or registering as an investment company, provided that (i) the number of U.S. persons who beneficially own securities of the fund does not exceed 100 and (ii) the fund does not propose to make a public offering of its securities. Alternatively, an offshore fund may exceed the 100-beneficial-owner limit if all of its U.S. investors are “qualified purchasers.” (See the discussion regarding Section 3(c)(7) above.)

Note that with respect to master-feeder structures, because the feeder funds are formed for the purpose of investing in a master fund, all of the investors in a feeder fund will be deemed to be the investors in a master fund for purposes of the above analyses.

This discussion of the Investment Company Act provides a purposefully truncated summary and omits a large number of rules and exceptions because a full analysis of the Investment Company Act is beyond the scope of this article.

The Advisers Act and “Qualified Clients”

Scope of Registration Requirements

The Advisers Act defines an “investment adviser” as any person who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. The Advisers Act covers investment advisers with assets of \$25 million or more under management. Investment advisers with less than \$25 million under management are to be regulated by the states. For those investment advisers subject to the Advisers Act, registration as an investment adviser with the SEC is required unless an exemption applies. Unlike the Securities Act, the Exchange Act, and the Investment Company Act, fund managers are not universally attempting to avoid registration under the Advisers Act. While many fund managers rely on exemptions to avoid registration as investment advisers under the Advisers Act, many other fund managers find registration a small price to pay for some of the benefits that being a registered investment adviser brings. Whether registration is appropriate depends on the nature of a fund manager’s business.

Benefits of Registration as an Investment Adviser

Some of the benefits of registration are that registered fund managers (i) may have 15 or more clients; (ii) will be able to allow significant participation by corporate pensions under the Employee Retirement Income Security Act of 1974, as amended; (iii) may attract certain government employee benefit plans that require their managers to be registered investment advisers; and (iv) will be permitted to hold themselves out broadly to the public as investment advisers to attract clients, generally, provided they do so in a manner that does not run afoul of the private placement of interests in their funds.

Qualified Client Requirements

If a fund manager registers as an investment adviser with the SEC, it is important to note that all of the fund’s investors must be “qualified clients” in order to enable the fund manager to receive performance-based compensation, which is yet another test of the status of the investor imposed

by the SEC. A “qualified client” includes, among others, a natural person or company who has a net worth (including assets and liabilities held jointly with a spouse) of more than \$1.5 million. Note that qualified purchasers under the Investment Company Act are automatically deemed qualified clients under the Advisers Act.

Private Investment Adviser Exemption

With respect to fund managers that do not view the benefits noted above as being sufficiently worth the expense and exposure created by registering as investment advisers with the SEC, there is an exemption for any investment adviser that during the course of the preceding 12 months has had fewer than 15 clients and that neither holds itself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under the Advisers Act. For purposes of this exemption, each fund managed by a fund manager is a client, not each investor in each fund.

Note that there is legislation pending as of the writing of this article that, if passed, will eliminate the private investment adviser exemption. Such legislation could result in requiring most fund managers to register with the SEC under the Advisers Act.

This discussion of the Advisers Act provides a purposefully truncated summary and omits a large number of rules and exceptions because a full analysis of the Advisers Act is beyond the scope of this article.

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For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

About Morgan Lewis’s Private Investment Funds Practice

Morgan Lewis has one of the nation’s largest private investment fund practices and is ranked the Second Most Active Law Firm in the U.S. based on the number of funds worked on for general and limited partners by *Dow Jones Private Equity Analyst* (2009).

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