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Private Fund Securities Law Exemptions: Accredited Investors, Qualified Purchasers, Subscription Limits, and More

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Investment Company Act of 1940

- Prohibits "investment companies" from engaging in interstate commerce unless registered or exempt.
- "Investment companies"—any issuer which:
  - is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
  - is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or
  - is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.
- Careful to avoid "inadvertent investment company"

ICA Exclusions

- Section 3(c) excludes from the definition of investment company:
  - ***Private Investment Companies – 3(c)(1)***
  - Underwriters, Brokers. Market Makers and Swap Dealers – 3(c)(2)
  - Insurance Companies, Banks and Savings and Loan Associations – 3(c)(3)
  - Credit Unions and Other Consumer Financing Agencies –3(c)(3) and 3(c)(4)
  - ***Commercial Financing and Mortgage Banking Businesses – 3(c)(5)***
  - Bank, Insurance, and Similar Holding Companies Diversified Operating and Holding Companies – 3(c)(6)
  - ***Qualified Purchaser Funds – 3(c)(7)***
  - Companies Subject to the Public Utility Holding Company Act – 3(c)(8)
  - Oil and Gas Funds –3(c)(9)
  - Charitable, Religious, and Similar Organizations – 3(c)(10)
  - Qualified Pension, Governmental, and Similar Plans – 3(c)(11)
  - Voting Trusts – 3(c)(12)
  - Security Holders' Protective Committees – 3(c)(13)
  - Church Employee Pension Plans – 3(c)(14)

ICA Exclusions for Private Funds

- Section 3(c)(1) –
  - Any issuer whose outstanding securities are beneficially owned by not more than 100 persons and who does not make a public offering.
- Section 3(c)(7) –
  - Any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are qualified purchasers, and who does not make a public offering.
- Reliance on other Section 3(c) exclusions
  - An issuer that qualifies for an exclusion in addition to those provided above may be treated as a "private fund", provided that the issuer is treated as a private fund under the Investment Advisers Act and the rules thereunder for all purposes.

Section 3(c)(1) Exclusion--Conditions

- Self-executing
- All of the issuer's outstanding securities must be beneficially owned by not more than 100 hundred persons (or in the case of a qualifying venture capital fund 250 persons) and that is not making and does not presently propose to make a public offering of such securities
  - Accredited investor thresholds;
  - No restrictions on fund activities
- The issuer must not be making and must not presently propose to make a public offering of its securities
  - An issuer will not be deemed to be making a public offering if its offering complies Securities Act Section 4(a)(2) or the safe harbor under Securities Act Rule 506 of Regulation D
- Note: an unregistered offshore fund can make a private offering in the US concurrently with a public offering outside the US and not violate section 7(d) if the offshore fund has no more than 100 beneficial owners resident in the U.S

Venture Capital Fund

- All of the issuer's outstanding securities must be beneficially owned by not more than 250 hundred persons
- A "qualifying venture capital fund" means a venture capital fund as defined under the Investment Advisers Act as:
  - Not registered as an investment company;
  - Represents to investors and potential investors that it pursues a venture capital strategy;
  - Holds no more than 20 percent of the amount of the fund's aggregate assets in non-qualifying investments
  - Restrictions on borrowing/debt/guarantees in excess of 15 percent of the private fund's aggregate assets
  - No right by holders to withdraw, redeem or require the repurchase of such securities
  - Not more than $10,000,000 in aggregate capital contributions and uncalled committed capital, with such dollar amount to be indexed for inflation once every 5 years

Counting Beneficial Owners

- Each individual investor is counted separately (count spouses who own jointly as one beneficial owner)
- Do not count a fund's general partner or managing member as such interests are not considered a security
- Do not count those who are knowledgeable employees at the time of investment
- Subject to the attribution "Look-through" rules, a "company" shall be counted as one person
- A transferee who acquired those interests pursuant to a gift, bequest or an agreement relating to a legal separation or divorce will be deemed beneficially owned by the transferor under certain conditions
- Don't count non-U.S. investors in offshore funds
- Don't count U.S. residents in offshore funds if purchased in an offshore secondary market purchase
- Don't double count the same person making multiple investments (i.e., through family trusts)

Beneficial Ownership by Knowledgeable Employees

Any natural person who is:

- An executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the fund or the fund's affiliated investment manager; or
- An employee of the fund or the fund's affiliated investment manager who:
  - Is not performing solely clerical, secretarial or administrative functions with regard to such company or its investments;
  - In connection with his or her regular functions or duties, participates in the investment activities of such fund, or other funds managed by that affiliated investment manager; and
  - Has been performing such functions and duties for or on behalf of the fund or the investment manager, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

Attribution "Look-through"

- When counting beneficial owners of a 3(c)(1) fund, there will be a "look-through" to
  - (i) the investor's underlying investors, if the investor owns 10% or more of the outstanding *voting securities* of the issuer and the investor is
    - (a) a fund-of-funds
    - (b) any other passive investment vehicle (including a family vehicle) relying upon Section 3(c)(1) or Section 3(c)(7), or
    - (c) a registered investment company
  - (ii) participants of any self-directed pension plan who have elected to have their plan monies invested in the 3(c)(1) fund
  - (iii) the owners of any entity formed for the purpose, or considered to have been formed for the purpose, of investing in the 3(c)(1) fund (i.e., if 40% or more of the entity's assets are invested in the 3(c)(1) fund), and/or
  - (iv) if the investor is a device for facilitating individual investment decisions (i.e., if the individual owners of the investor can decide whether or how much of their own capital contribution to that entity may be invested in the private fund)

Integration Doctrine

- The SEC will integrate two or more virtually identical private funds for determining compliance with Section 3(c)(1)'s 100 beneficial owner limit.
  - 3(c)(7) funds are **not** integrated with parallel 3(c)(1) funds
- Factors considered:
  - Five Factor Test
    - Are the offerings part of a single plan of financing?
    - Do the offerings involve the same class of securities?
    - Are the offerings made at the same time?
    - Do the offerings involve the same type consideration?
    - Are the offerings made for the same general purpose?
  - Intra-Regulation D Combination (i.e., combination of Rule 506 with any other available exemption under Regulation D), same Five-Factor Test, except where: (i) six months had passed between the completion of the first offering and the start of the second and (ii) there were no intervening offers or sales of similar securities
  - Additional Considerations
    - Do the entities share the same or similar investment objectives, investment portfolios and risk/return characteristics?
    - Are the funds intended for the same group of investors?
    - Would a reasonable investor view the interests as not being materially different?

Section 3(c)(7) Exclusion--Conditions

- Self-executing
- All of the issuer's outstanding securities of must be owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchasers"
  - No ICA limitations on quantity of investors, but Exchange Act Section 12(g) registration thresholds apply; no restrictions on fund activities
- The issuer must not be making and must not presently propose to make a public offering of its securities
  - An issuer will not be deemed to be making a public offering if its offering complies Securities Act Section 4(a)(2) or the safe harbor under Securities Act Rule 506 of Regulation D
- Note: an unregistered offshore fund can make a private offering in the US concurrently with a public offering outside the US and not violate section 7(d) if the all U.S. resident owners are qualified purchasers.

Definition of "Qualified Purchaser"

- Statutory definition:
  - (i) any natural person (including any person together with their spouse) who owns not less than $5 million in "investments"
  - (ii) any company that owns not less than $5 million in "investments" and that is owned directly or indirectly by or for 2 or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organizations, or trusts established by or for the benefit of such persons;
  - (iii) any trust that is not covered by clause (ii) and that was not formed for the specific purpose of acquiring the securities offered, as to which the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clause (i), (ii), or (iv); or
  - (iv) any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than $25 million in investments.
- The term "investments" is interpreted broadly to include the value (net of liabilities) of a wide array of items held for investment purposes including securities, real estate, commodities, financial contracts, insurance policies, and cash or cash equivalents.

"Qualified Purchaser"—Special Circumstances for Qualification

- Knowledgeable employees under ICA Rule 3c-5
- Qualified institutional buyers (QIBs) under Securities Act Rule 144A acting on their own account on the account of another QIB or the account of a qualified purchaser, with certain exceptions.
- A company formed for the specific purpose of acquiring the securities offered by a section 3(c)(7) company will not be a qualified purchaser unless each beneficial owner of the company's securities is a qualified purchaser.
- A company may be deemed to be a qualified purchaser if each beneficial owner of the company's securities is a qualified purchaser.
- A transferee who acquired those interests pursuant to a gift, bequest or an agreement relating to a legal separation or divorce from a qualified purchaser will be deemed to be a qualified purchaser under certain conditions.
- "Look-through" an IRA or self-directed account of a retirement plan to determine whether the participant is a qualified purchaser

Section 3(c)(5)(c) Exclusion--Conditions

- Real Estate Fund is investing in securities (and therefore needs to find an exclusion from registration) but does not want to be bound by the requirements of Section 3(c)(1) or 3(c)(7)
- Section 3(c)(5)(c) –
  - "not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates..." and is "primarily engaged in ... purchasing or otherwise acquiring mortgages and other liens on and interests in real estate.“
- “Asset Composition Test” for determining “primarily engaged”
  - must invest at least 80% of its assets as follows: (A) not less than 55% thereof in Qualifying Interests; plus (B) up to 25% thereof in "real estate related assets";
  - and (2) may invest up to 20% of its assets without restriction.
- Qualifying Interests are assets that represent an actual interest in real estate or are loans or liens fully secured by real estate.

K&L GATES

SECURITIES ACT OF 1933

- Fundamental principle: every sale of a security in the United States must be registered under Section 5 of the Securities Act of 1933 (the "1933 Act") unless an exemption is available
- Reliance on the Section 4(a)(2) exemption in the 1933 Act is essential for a fund seeking to rely on the Section 3(c)(1) or Section 3(c)(7) exception from registration under the Investment Company Act of 1940

PRIVATE PLACEMENT EXEMPTION: SECTION 4(A)(2)

- Section 4(a)(2) of the 1933 Act is the so-called private placement exemption. But Section 4(a)(2) neither uses the term "private offering" nor defines it.
- Rather, it provides an exemption from the registration requirements of the 1933 Act for "transactions by an issuer not involving any public offering."

PRIVATE PLACEMENT EXEMPTION: SECTION 4(A)(2) (CONTINUED)

- For almost 50 years, there was very little definitive guidance regarding the requirements for making a valid private offering under Section 4(a)(2)
  - In 1954 the U.S. Supreme Court held that to fall within Section 4(a)(2) the issuer should offer securities only to persons who are sufficiently sophisticated that they can watch out for their own interests and do not need the protections afforded by the 1933 Act
  - The Court decision, while helpful, puts the burden on the issuer to make subjective determinations about the sophistication of the prospective investors
  - Uncertainty in regard to the requirements for conducting a valid private offering works against the issuer of the securities, because the issuer would have the burden of proving the availability of the Section 4(a)(2) exemption if it were ever challenged.

REGULATION D

- Finally, in 1982, the SEC adopted a series of rules, collectively designated Regulation D
  - Regulation D provides certain issuers with safe harbors from the registration and prospectus delivery requirements of the 1933 Act
- Regulation D was designed to clarify existing exemptions and facilitate capital formation consistent with the protection of investors.

ACCREDITED INVESTORS

The linchpin of Regulation D is the definition of "Accredited Investor." An Accredited Investor is an investor that the Commission has deemed to be able to watch out for its own interests.

By defining "accredited investor" using specific net worth, income and other tests, the SEC provided objective standards as proxies for investor sophistication so that the issuer would not have to make subjective determinations.

- Under Rule 501(a), a person is an accredited investor if
  - That person comes within one of thirteen categories set forth in Rule 501(a) at the time of the sale, or
  - The issuer "reasonably believes" at the time of the sale that the purchaser comes within one of those categories
- Therefore, if a purchaser misrepresents itself as an accredited investor to an issuer, the issuer will not lose the ability to rely on Rule 506, so long as the issuer had a reasonable belief that such purchaser was an accredited investor at the time of sale.

ACCREDITED INVESTORS (CONT.)

- The thirteen categories of "accredited investors" provided in Rule 501(a) include:
  - An individual with a net worth (or joint net worth with spouse or spousal equivalent) in excess of $1 million, excluding the value of their primary residence. Assets need not be owned jointly to be counted. Reliance on the joint net worth standard does not require that the securities be purchased jointly.
  - An individual with income in excess of $200,000 (or $300,000 joint income with spouse or spousal equivalent) in each of the last two years and who reasonably expects to have income in excess of $200,000 (or joint income in excess of $300,000) in the current year.
  - A corporation, partnership or limited liability company with assets in excess of $5 million that was not formed for the specific purpose of acquiring the securities offered.

NEW CATEGORIES OF ACCREDITED INVESTORS

- Effective December 8, 2020, the SEC amended Regulation D to include additional categories of accredited investors. These include, among others:
  - Any rural business investment company (RBIC);
  - Any individual who has a professional certification, designation or credential from an accredited educational institution that the SEC designates as qualifying for accredited investor status. The SEC has already designated Series 7, Series 65 and Series 82;
  - Any individual who is a "knowledgeable employee" of a "private fund," which is defined to include an issuer that would be an investment company, but for the exclusions provided by Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940;
  - Any family office with at least $5 million in assets under management and that was not formed for the specific purpose of acquiring the securities offered, and whose investment is directed by a person capable of evaluating the merits and risks of the prospective investment; and
  - Any family client of a family office described in the prior bullet point whose prospective investment is directed by that family office.

REGULATION D: RULE 506

- Rule 506 of Regulation D provides two non-exclusive safe harbors
  - An issuer that meets the requirements of Rule 506(b) or Rule 506(c) is deemed to have made an offering exempt from registration under Section 4(a)(2) of the 1933 Act.
  - An issuer may conduct a valid private placement under Section 4(a)(2) without relying on Rule 506, but an issuer that relies on Rule 506 would likely be in a better position to defend the availability of the Section 4(a)(2) exemption if it were ever challenged.

RULE 506(B)

Under Rule 506(b):

- Neither the issuer nor any person acting on its behalf may offer or sell the securities by any form of general solicitation or general advertising. The securities cannot be offered over the Internet, over the radio, in newspaper advertisements, or in any other public medium.
- Under Rule 506(b), an issuer generally may sell an unlimited dollar amount of securities to: i) up to 35 non-accredited investors in offerings under Rule 506(b) in any 90 calendar day period; and ii) an unlimited number of "accredited investors."
- Every non-accredited investor must alone or with its purchaser representative have such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment, or the issuer must reasonably believe the investor meets this standard.
- As a practical matter, almost all sponsors of private funds that rely on Rule 506(b) sell securities only to accredited investors. A sale to a non-accredited investor triggers an onerous disclosure requirement under Rule 502 of Regulation D that would otherwise not apply.

RULE 506(C)

- Rule 506(c) permits the issuer and persons acting on its behalf to offer and sell the securities using general solicitation and general advertising.
- Rule 506 requires that securities be sold only to accredited investors.
- Rule 506 requires the issuer to take "reasonable steps" to verify the accredited status of the purchasers, which goes beyond what Rule 506(b) requires.

RULE 506(C) (CONT.)

- Rule 506(c) provides four non-exclusive and non-mandatory ways of verifying the accredited status of natural persons. These safe harbors include:
  - Verifying income using Form W-2, Form 1099, Schedule K-1, and Form 1040. Many prospective investors are reluctant to provide these documents to the issuer.
  - Verifying net worth using (with respect to assets) bank statements, brokerage statements, and appraisals from independent third parties and (with respect to liabilities) a consumer report.
  - Obtaining a confirmation from a registered broker/dealer, an investment adviser, an attorney, or a CPA that they have taken reasonable steps to verify that the individual is an accredited investor and determined that the individual is an accredited investor.
- If an issuer of securities has previously taken steps as described above to verify the accredited status of an investor, so long as the issuer is not aware of information to the contrary, obtaining a written confirmation from the investor that he or she qualifies as an accredited investor will satisfy the issuer's obligation to verify accredited status for five years from the time the issuer previously verified the investor's accredited status.

PRE-EXISTING RELATIONSHIP REQUIREMENTS

- SEC guidance provides that the safest way to avoid a general solicitation is for the issuer to offer and sell securities only to prospective offerees with which it has a substantive, pre-existing relationship
  - Such a relationship enables an issuer to evaluate the prospective offeree's financial circumstances and sophistication.
  - However, many issuers have a limited number of such relationships, which limits their ability to raise capital under Rule 506(b).

NO-ACTION RELIEF

- In August 2015, the SEC issued a no-action letter that addressed this issue.
- In Citizen VC, Inc., the issuer used an online venture capital investment platform and employed certain procedures to establish substantive, pre-existing relationships with purchasers
  - The SEC agreed that an issuer of securities can create its own substantive, pre-existing relationships with prospective offerees through procedures such as those established by Citizen VC
  - Moreover, the SEC indicated that to establish such a relationship there is no minimum waiting period

RULE 506: FEDERAL FILING REQUIREMENTS

- When making an offering in reliance on Rule 506, the issuer must file Form D
  - Rule 503 requires that Form D be filed with the SEC within 15 calendar days of first sale
  - A sale may be deemed to have occurred when the first subscription is received, so it is advisable to file Form D when the offering commences
- Form D must be renewed annually for as long as the offering continues, and requires basic information about the issuer and the offering be updated at each renewal, including:
  - The total amount of securities sold
  - The total number of investors
  - The total sales commissions paid

RULE 506: BAD ACTOR

- An issuer is disqualified from relying on Rule 506 if any of its "covered persons":
  - Has an undisclosed "disqualifying event" that occurred prior to September 23, 2013; or
  - Is subject to a "disqualifying event" that occurs on or after September 23, 2013
- "Disqualifying Events" are set forth in Rule 506(d) and include conviction of a felony or misdemeanor in connection with the purchase or sale of a security or in connection with a false filing with the Commission.
- The Rule 506 safe harbor is not lost if the issuer did not know and could not reasonably have known of the "disqualifying event" after exercising reasonable care to discover such event
- If an issuer cannot rely on Rule 506:
  - Section 4(a)(2) may be available, but securities being offered would no longer be considered "covered securities," and therefore the offering would be subject to state law requirements
  - Section 4(a)(2) does not permit general solicitation or general advertising

MAINTAINING CONTEMPORANEOUS RECORDS

It is not enough for an issuer of securities to meet all of the requirements of Rule 506(b) or Rule 506(c) of Regulation D. If the availability of the private placement exemption were ever challenged (by a disgruntled investor, for example), the issuer would have the burden of proving that it met all of the requirements of the applicable safe harbor. The issuer must retain contemporaneous records to be able to prove that it met all the requirements of the applicable safe harbor.

STATE REGULATION OF RULE 506 OFFERINGS

The states are forbidden to regulate offerings of securities that are made pursuant to Rule 506 of Regulation D. However, the states retain anti-fraud authority, and most states require that notice filings be made and that filing fees be paid, usually within 15 days of the sale of the security. An issuer that ignores these state requirements may be subject to substantial fines and may be required by the states to make rescission offers to its investors. Note that the states are not preempted from regulating offerings of securities made pursuant to Section 4(a)(2) without the benefit of the safe harbor in Rule 506. This is one of many reasons for issuers to avail themselves of Rule 506.

REGULATION S

- Regulation S tells us that the registration requirements of the 1933 Act apply only to offers and sales of securities in the United States. Offers and sales of securities that occur outside the United States should not be required to be registered under the 1933 Act.
- But in a world in which businesses and transactions are increasingly international in nature, those general principles can be difficult to apply.

REGULATION S SAFE HARBOR

- Regulation S provides a safe harbor from registration under the 1933 Act for issuers, selling agents and their affiliates.
- To qualify for this safe harbor:
  - the securities must be sold in an “offshore transaction”;
  - there must be no “directed selling efforts” in the United States; and
  - certain other requirements are met, depending on the nature of the issuer.

"OFFSHORE TRANSACTION"

- An offer or sale is an "offshore transaction" if the offer is made outside the United States and:
  - the buyer itself is outside the US when the buy order is originated; or
  - the transaction is executed on the physical trading floor of a foreign securities exchange.

"DIRECTED SELLING EFFORTS"

- "Directed selling efforts" are activities that are undertaken for the purpose of conditioning the U.S. market for the securities being offered. Since the offer and sale are supposed to be outside the U.S., the issuer should not be generating interest in its securities in the U.S.

REGULATION S & REGULATION D

- An issuer may conduct a Regulation D offering in the U.S. simultaneously with a Regulation S offering outside the U.S., and the private placement activities within the U.S. will not generally be considered “directed selling efforts” in the U.S. for purposes of Regulation S.

Securities Exchange Act of 1934

- Regulates securities exchanges and over-the-counter markets operating in interstate commerce and through the U.S. mails.
- Regulation of broker-dealers, transfer agents, clearing agencies and securities self-regulatory organizations.
- Requires public reporting of companies with publicly traded securities.

34 Act – Issuer Registration

- Section 12(g) and Rule 12g-1 together require the registration of an issuer that meets the following thresholds:
  - Total assets exceeding $10 million; and
  - 2,000 or more investors or 500 unaccredited investors

34 Act - Broker-Dealer Registration

- Broker-dealer registration
  - Section 15(a) makes it unlawful for a "broker" or a "dealer" to effect any transactions in or to induce or attempt to induce the purchase or sale of any security (other than an exempted security) unless such broker or dealer is registered with the SEC.
  - The term "broker" is defined as "any person *engaged in the business* of *effecting transactions in securities* for the account of *others*."

34 Act – Broker – Factors to Consider

- Transaction-based compensation
- Holding out to the public
- Solicitation activities
- Order-taking activities
- Previous history of being registered as a broker-dealer

34 Act – Rule 3a4-1 Safe Harbor

- Rule 3a4-1 is a "non-exclusive safe-harbor" for an "associated person" of an issuer in certain limited circumstances.
- Must meet the following preliminary conditions.
  - The associated person must not be subject to a statutory disqualification, as defined in Section 3(a)(39) of the Exchange Act, at the time of his or her participation in the sale of the issuer's securities
  - The associated person must not be compensated in connection with the sale of the issuer's securities **by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities**
  - The associated person must not be an associated person of a broker or dealer at the time of the sale
- An issuer may only use this exemption ***once*** in a 12 month period.

34 Act – Rule 3a4-1 Safe Harbor

- In addition to satisfying each of the preliminary conditions, additional conditions apply:
  - Limits the sales only to broker-dealers and other specified types of financial institutions.
  - Limits activities to delivering written communications by means that do not involve oral solicitation by the associated person of a potential purchaser.

34 Act – M&A Brokers Letter

- 2014 SEC staff no-action letter – M&A Broker – engaged in the business of effecting securities transactions solely in connection with a business transaction with a buyer that will actively operate the privately-held company.
- Several Conditions, including that the M&A Broker cannot:
  - Have the ability to bind the party to an M&A transaction;
  - Provide financing for the transaction;
  - Have custody, control or possession of or otherwise handle securities or funds from the transaction or any other securities transaction.

34 Act – Consequences of Acting as a Broker Without being Registered

- *In re Ranieri Partners LLC* (2013) – violation of Section 15(a) in connection with soliciting investors for private equity funds.
- *In re Blackstreet Capital Management* (2016) – violation of Section 15(a) for charging transaction fees with respect to the acquisition and disposition of portfolio companies ("soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing and executing the transactions").
- *In re Neovest, Inc.* (2021) – violation of Section 15(a) in connection with the receipt of transaction fees for equity and option orders routed through an order and execution management system platform.
- *SEC v. Joshua Louis Rupp* (2021) – violation of Section 15(a) in connection with unregistered brokerage activities.

Investment Advisers Act of 1940

- The Investment Advisers Act of 1940 is the centerpiece of U.S. regulation of money managers.
- The Advisers Act requires an investment adviser to register with the SEC, unless an applicable exemption applies.
- Under federal law, an investment adviser is a fiduciary – duty of care and duty of loyalty.

Advisers Act - Definition of Investment Adviser

- Section 202(a)(11) of the Advisers Act
  - Three-part definition — Any person who
    1. For compensation
    2. Engages in the business of advising others directly or through publications or writings
    3. As to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as a part of a regular business, issues or promulgates analyses or reports concerning securities

- All three elements need to be met for a person or entity to be deemed an investment adviser.

Advisers Act - Exclusions

- Banks
- Broker – Dealers
- Nationally Recognized Statistical Rating Organizations (NRSROs)
- Publishers (*Lowe v. SEC* and *Tokyo Joe*)
- Lawyers and Accountants
- Family Offices (Dodd Frank) – Rule 202(a)(11)(G)-1 under the Advisers Act

Advisers Act – Section 203A Preclusions

- The Advisers Act *precludes* an investment adviser from registering if the adviser, among other things, has less than **$25 million** in AUM.
- Dodd Frank added another preclusion with the effect that "mid-sized" advisers (AUM between **$25 million and $100 million**) located in the US are generally *precluded* from registering with the SEC.

1) Under $25 million in RAUM
2) Between $25 million and $100 million in RAUM
3) Over $100 million in RAUM

Advisers Act - Exemptions for Private Fund Advisers

Exemption	Acceptable Clients	AUM Limits	Reporting Requirements
Foreign Private Adviser (no place of business in the U.S.) – Section 203(b)(3)	- No more than 15 clients or investors in the U.S.	- No more than $25 million in AUM attributable to U.S. clients or investors	- Exempt from reporting on Form ADV
Venture Capital Fund Adviser – Section 203(l)	- All clients must be "venture capital funds" - No more than 20% in non-"qualifying investments" and may not borrow more than 15% of assets	- No AUM limit	- Files as an "exempt reporting adviser" on Form ADV
U.S. Private Fund Adviser (principal place of business in the U.S.) – Section 203(m)	- All clients must be "private funds"	- No more than $150 million in aggregate private fund AUM	- Files as an "exempt reporting adviser" on Form ADV
Non-U.S. Private Fund Adviser (principal place of business outside of the U.S.) – Section 203(m)	- All U.S. clients must be "private funds" - All clients advised from U.S. must be "private funds"	- Assets managed from U.S. limited to $150 million - No limit on assets managed from non-U.S.	- Files as an "exempt reporting adviser" on Form ADV

Advisers Act – Exempt Reporting Advisers

- Exemption from SEC registration only
- ERAs are subject to the anti-fraud provisions and certain other provisions of and under the Advisers Act:
  - Sections 206(1) and (2) – unlawful to "employ any device, scheme, or artifice to defraud any client or prospective client" or to "engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client"
  - Rule 206(4)-8 Section 206(3) – principal transactions
  - Rule 206(4)-5 – "pay to play" rule
  - Section 204A of the Advisers Act – policies and procedures reasonably designed to prevent the misuse of MNPI
- SEC examination and enforcement

Advisers Act - Section 205—Compensation Prohibition

- Section 205(a)(1) prohibits a registered investment adviser from receiving a fee on the basis of a share of capital gains or capital appreciation of a client's funds, unless the Adviser can meet the terms and conditions of Rule 205-3 under the Advisers Act.
- Rule 205-3 – permits a registered adviser to receive a performance-based fee from "qualified clients."

Advisers Act – Rule 205-3 "Qualified Client"

- The SEC recently adjusted the AUM and net worth tests for “qualified clients,” effective as of August 16, 2021.
- A natural person who, or a company that, immediately after entering into the contract has at least **$1.1 million** under the management of the investment adviser;
- A natural person who, or a company that, the investment adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:
  - Has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than **$2.2 million**; or
  - Is a qualified purchaser at the time the contract is entered into; or
- A natural person who immediately prior to entering into the contract is:
  - An executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or
  - An employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser, provided that such employee has been performing such functions and duties for or on behalf of the investment adviser, or substantially similar functions or duties for or on behalf of another company for at least 12 months.

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