THE REAL ESTATE SECURITIES JOURNAL®

VOLUME 7; NUMBER 2 1986

Corporations, Partnerships and Trusts as Purchasers Under Regulation D

By Marc H. Morgenstern

REAL ESTATE SECURITIES AND SYNDICATION INSTITUTE®

Corporations, Partnerships and Trusts as Purchasers Under Regulation D

By Marc H. Morgenstern

Regulation D[1] consists of six rules: 501 through 506. Compliance with Rules 501 (common definitions),[2] 502 (general conditions)[3] and 503 (filing of notice of sales)[4] is a prerequisite to each of the exemptions from federal registration of a security[5] afforded by Rules 504,[6] 505[7] or 506.[8] Rules 505 and 506 each allow an issuer to sell securities to 35 non-accredited investors and an unlimited number of accredited investors.[9]

Given the statutory framework, two issues become important when dealing with entities such as corporations, partnerships and trusts as purchasers in a Regulation D offering. First, should the entity be treated as a single purchaser or must the issuer disregard the entity and treat the equity owners of the entity as individual purchasers? Second, is the entity an accredited or non-accredited investor? The resolution of these issues for corporations, partnerships or trusts requires careful and thoughtful scrutiny.

This article discusses the applicable rules with respect to corporations, partnerships and trusts as purchasers under Regulation D. Section I addresses the central issue whether a corporation, partnership, or trust should be counted as one or more purchasers. Section II treats three factors which affect the determination of whether an entity is an accredited investor. Sections III, IV and V deal with issues peculiar to corporations, partnerships and trusts, respectively, and Section VI is a brief conclusion.

I. The Entity as a Single or Multiple Purchaser

A. Introduction

Rule 501(e)(2) begins with language that will delight any issuer or broker-dealer concerned with complying with the limitation that only 35 non-accredited investors can purchase securities in an offering under Rules 505 or 506. It provides that "[a] corporation, partnership or other entity shall be counted as one

©Copyright 1986 by Marc H. Morgenstern. All rights reserved.

Marc H. Morgenstern is a principal in the Cleveland, Ohio law firm of Kahn, Kleinman, Yanowitz & Arnson Co., L.P.A. Mr. Morgenstern received his B.A. in 1972 from Yale University and his J.D. from Boston University in 1975.

purchaser."[10] This forthright statement is modified, however, by a significant qualifier:

> ... If, however, that entity is organized for the specific purpose of acquiring the securities offered and is not an accredited investor under paragraph (a)(8) of this §230.501, then each beneficial owner of equity securities or equity interests in the entity shall count as a separate purchaser for all provisions of Regulation D.[11]

Thus, if a corporation was established specifically to buy a particular security and that corporation is not an accredited investor under 501(a)(8), each of its shareholders must be counted as a purchaser just as all of the partners of a partnership would be counted if the newly formed entity were a partnership.

This limitation affects corporations, partnerships, trusts and other entities. Accordingly, issuers must understand the philosophical and practical basis for the restriction as well as the basic methods for complying with the regulation. Although only Rule 506 is specifically promulgated under the private placement provisions of Section 4(2) of the Securities Act,[12] certain aspects of the philosophy of the statutory private placement framework are carried over in Regulation D. As an example, Rule 502(c)[13] prohibits general solicitation and advertising under Rules 504,[14] 505, and 506, a restriction reflecting case law development under Section 4(2).

The practical basis for the qualifying language is obvious. An issuer cannot achieve indirectly that which cannot be achieved directly. Therefore, a public offering cannot be restructured as an exempt transaction through the simple transmutation of multiple purchasers into a limited number of single entities. If an issuer were permitted to allow potential purchasers of its securities to band together in entity form to acquire its securities, then 350 purchasers could be grouped in 35 partnerships or corporations of 10 persons each so that there would be only 35 purchasers of record. This form of blatant manipulation is clearly prohibited; and few, if any, issuers would find it difficult to understand, or comply with, the language or intent of the rule in that context.

What frequently gives rise to interpretative issues, by contrast, is measurement of the subjective intent — was an entity formed for the specific purpose of acquiring a particular security? Important factors are the relationship among the beneficial owners of the entity, the stated and apparent purpose of forming the entity, and the time of formation relative to the inception of the offering. What may be the most direct statement of the SEC's analytical matrix on this issue is found in SEC No-Action Letter, Hall Moneytree Associates Limited Partnership,[15] where the staff offered the following observation:

> No one factor will determine whether an entity should be regarded as organized for the specific purpose of making an investment. Any analysis of this issue must consider all facts and circumstances. Significant factors would include the existence and nature of prior activities by the entity, the structure of the

entity (i.e., whether the entity has centralized management and decision making), the proposed activities of the entity, the relationship between the entity's investment in the Regulation D offering and the entity's capitalization, and the extent to which all equity owners of the entity participate in all investments by the entity.

In short, no mere mechanical formula can be rigidly followed. Instead, the issuer must examine the totality of the circumstances.

B. Investment Partnerships

In practice, the most commonly recurring problem may well be posed by investment partnerships as purchasers. Delicate questions arise when the partnership is new, its stated purpose is to serve as an investment vehicle, and the security in a Regulation D offering is to be the partnership's first purchase. Although it is possible that the investment partnership was formed for purposes broader than investing in a particular offering, it is also possible that it was formed for precisely such a purpose. If the partnership was formed specifically to acquire a particular security, then each partner must be counted as a purchaser for determining compliance with the purchaser limitations of Rules 505 and 506.

The issuer should focus on the partners in the partnership. A common practice is for a family (or business acquaintances) to have been investing together for some time and only recently to have had the need, or the desire, to formalize the existing relationship. This partnership may well contemplate an ongoing series of investments and qualify as a single purchaser since it was not formed for the specific purpose of acquiring the security in question.

Unfortunately, an equally frequent occurrence is that a newly formed investment partnership is composed of several non-accredited individuals with no prior business relationship who are trying to purchase a security in an offering that had already accepted subscriptions from 34 non-accredited investors. The investors' goal is to be treated as an entity — constituting only a single non-accredited investor — thereby permitting the issuer to remain within the 35 non-accredited investor limitation. Such partnership, formed at the time of the offering, is clearly not a partnership that could properly be treated as only one purchaser. Each of its partners would be counted as purchasers.

The consequences of selling securities to more than 35 non-accredited purchasers in a Rule 505 or 506 offering are extremely serious. The issuer loses the Regulation D exemption from registration and, unless another exemption is available, bears the concomitant liability for having sold a security in violation of Section 5 of the Securities Act. Issuers are, therefore, advised to be extremely conservative in interpreting the status of investment partnerships and to err on the side of assuming that each partner is a purchaser when calculating the number of purchasers.

C. Proper Documentation

The issuer must create an appropriate review process to conclude that an entity is only a single purchaser within the meaning of Rule 501(e)(2). The purchaser's subscription agreements and related documents, as well as direct conversations with the purchaser, provide the cornerstone of this analysis. The following constitute the minimum representations to be obtained from purchasers which are entities. First, mirroring the statutory language, the entity was not formed for the specific purpose of acquiring the security. Second, the entity has been in existence for at least three months prior to the date the offering commenced.[16] While not conclusive, the fact that the entity was established prior to the offering suggests that it was not formed to acquire the particular security.

The subscriber must additionally acknowledge that the issuer and broker-dealer are relying on the accuracy of the subscriber's representations, which are critical to the existence of the Regulation D exemption. The subscriber should indemnify and hold harmless the issuer, broker-dealer, counsel, and other persons associated with the offering in the event that such representations are untrue. Prudent issuers will also insist on receiving, and reviewing, a certified copy of the subscriber's Articles of Incorporation, By-laws, partnership agreement or trust document to verify that the subscriber's representations do not conflict with the written agreements.

An issuer that complies with the foregoing can tell whether a purchasing entity can be counted as a single purchaser or whether the entity must be disregarded and each of its owners included in the calculation of the number of purchasers.

The philosophical issue of whether a corporation, partnership or trust should be viewed as an entity, or as an aggregate of its equity owners, arises elsewhere under Regulation D and will be addressed in different contexts in later sections of this article.

II. Accredited Investors

After an issuer has concluded who the purchaser is, the next significant issue is whether the purchaser qualifies as an accredited or non-accredited investor. This is critical for two reasons. First, under Rules 505 and 506, an issuer can only sell to 35 non-accredited investors; but it can sell to an unlimited number of accredited investors. Additionally, Rule 502(b)(1)(i) provides that a Regulation D offering made exclusively to accredited investors has no mandated narrative or financial disclosure requirements. By contrast, if even one non-accredited investor purchases securities, the issuer must comply with the extensive information disclosures (narrative and financial) required by Rule 502(b)(2).[17]

Regulation D provides eight broad categories of persons (which term includes entities) who can qualify as accredited investors. Whether corporations for profit (excluding banks, insurance companies, investment companies and private

business development companies),[18] partnerships or trusts are accredited investors depends primarily upon Rules 501(a)(4)-(8), which provide that the following persons are accredited investors:

> ...(4) Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer;
>
> (5) Any person who purchases at least $150,000 of the securities being offered, where the purchaser's total purchase price does not exceed 20 percent of the purchaser's net worth at the time of sale, or joint net worth with that person's spouse, for one or any combination of the following: (i) cash, (ii) securities for which market quotations are readily available, (iii) an unconditional obligation to pay cash or securities for which market quotations are readily available, which obligation is to be discharged within five years of the sale of the securities to the purchaser, or (iv) the cancellation of any indebtedness owed by the issuer to the purchaser;
>
> (6) Any natural person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000;
>
> (7) Any natural person who had an individual income in excess of $200,000 in each of the two most recent years and who reasonably expects an income in excess of $200,000 in the current year; and
>
> (8) Any entity in which all of the equity owners are accredited investors under paragraph (a)(1), (2), (3), (4), (6) or (7) of this §230.501.

Corporations, partnerships and trusts will ordinarily be accredited investors if they can qualify pursuant to Rule 501(a)(5), as $150,000 purchasers, and Rule 501(a)(8), because all of the entity's equity owners are accredited investors. Partnerships may additionally be impacted by Rule 501(a)(4), while certain trusts may also qualify indirectly pursuant to Rule 501(a)(1).

The balance of Section II of this article examines three facets of the accredited investor concept that apply equally to corporations, partnerships and trusts as purchasers. First, what analysis and methodology permit an issuer to conclude that an entity is an accredited investor? Second, how is the $150,000 purchase price computed under Rule 501(a)(5)? Finally, what are the broad principles enunciated in Rule 501(a)(8) providing that an entity owned entirely by accredited investors is itself an accredited investor?

A. How Does an Issuer Know that a Purchaser is an Accredited Investor?

The introductory clause to Rule 501 provides that an accredited investor is any person who either actually falls within any of the eight categories of persons who are accredited investors or "who the issuer reasonably believes" satisfies such categories at the time of sale. If the investor actually qualifies as an accredited

investor, then the rule is satisfied and the issuer has no problem with complying with this aspect of Regulation D. This is true even if the issuer did not know that the purchaser was an accredited investor. The second half of the clause, introducing the concept of "reasonable belief," however, creates an exceedingly troublesome issue — what is the basis for reasonable belief? What due diligence, if any, must an issuer conduct to form that belief?

The SEC has offered no guidance in this area. Some issuers and their counsel practice what can best be characterized as "self-accreditation." The purchaser simply confirms to the issuer that the purchaser is an accredited investor. At the other extreme, some issuers require investors to complete a lengthy purchaser questionnaire indicating sources and amount of annual income, bank references, net worth, other investments and educational background, among other factors. The issuer reviews this information and uses the facts furnished by the investor as its basis for analysis.

Under the self-accreditation concept, a potential investor simply checks a box in the subscription documents indicating that he understands the eight bases pursuant to which he could be an accredited investor and that, in fact, the investor constitutes an accredited investor pursuant to at least one such classification. A common variation for offerings aimed primarily at natural persons is a representation that the subscriber is an accredited investor pursuant to Rule 501(a)(6) because the purchaser, and his spouse, have a combined net worth of $1,000,000 or more. The proponents of the self-accreditation system aver that such an approach adequately protects the issuer. The investor's representation provides the issuer reasonable basis for believing that the purchaser is an accredited investor unless the issuer has an affirmative basis for believing that such information is not true.

Those who favor the questionnaire approach feel that a potentially self-serving, self-accreditation philosophy is inadequate. It encourages investors to either misunderstand or misapply legal standards and/or to misrepresent facts.

The goal of the questionnaire approach is for the issuer to review extensive information about the investor's prior investments, educational background, income, net worth and other factors. If that information is consistent with other information possessed by the issuer and confirms the investor's accredited investor status and the issuer has no reason to disbelieve the information, the conjunction of those facts seems to form a secure and reasonable basis for the issuer to believe that the investor is accredited. Although the investor can still misrepresent facts, it is harder to do so. Furthermore, the application of the legal analysis of those facts rests with the issuer rather than the purchaser.

The questionnaire approach appears more prudent than the self-accreditation method, because the issuer has taken at least one additional step beyond simple self-accreditation. This approach, however, is not without its own set of problems. May the issuer simply rely on the investor's representations or does it have an affirmative duty to verify that information with the investor's lawyers, accountants or bankers? Can an issuer rely on the investor's valuation of his

closely held business and other illiquid assets without a readily ascertainable market value when confirming that the investor has a $1,000,000 net worth for purposes of Rule 501(a)(6)? If the issuer does not take those additional steps, can it truly be said to have a reasonable basis for believing that the facts are as represented? There are no indications from the SEC or elsewhere that these additional steps are necessary. By the same token, the issuer cannot accept facts on blind faith if a reasonable person would have reason to disbelieve them.

In many (if not most) Regulation D offerings, the reality is that the responses to the questionnaires are inadequately policed by the issuer. Some investors refuse to answer certain portions of the questionnaire. Others answer in a manner that is either internally inconsistent or inconsistent with the information previously given by that investor to the issuer or broker-dealer in other transactions. If the availability of the exemption is subsequently subject to litigation, these potentially damaging documents may indicate that the issuer did not have had a reasonable basis for believing that the purchaser was an accredited investor. Those who favor the self-accreditation concept argue that their approach, by contrast, prevents this potential evidentiary nightmare.

There is no definitive answer to which approach is preferable. However, for entities, unlike natural persons, certain facts are purely objective, i.e., the net worth of an entity can be easily determined by reference to its financial statements. On balance, when dealing with entities, an issuer is well-advised to adopt the questionnaire approach and receive and review the purchaser's most recent financial statements. Despite the burdens and time pressures involved in an offering, issuers and broker-dealers must establish internal procedures that will result in properly documented questionnaires. Steps should also be taken to record and preserve any additional relevant information about the investor obtained by the issuer.

B. $150,000 Purchasers as Accredited Investors

In addition to other entities, corporations, partnerships and trusts can each qualify as accredited investors under Rule 501(a)(5). That section provides that a person is an accredited investor if both of the following conditions are satisfied: (1) the purchaser acquires at least $150,000 of the securities being offered; and (2) the total purchase price does not exceed 20% of the purchaser's net worth at the time of sale.[19] Payment must consist of either: (1) cash; (2) securities with readily available market quotations; (3) unconditional obligations to pay either cash or securities with readily available market quotations, which obligation must be discharged within five years of the date of sale; or (4) cancellation of indebtedness.

The initial condition precedent under Rule 501(a)(5) is that a purchaser acquire at least $150,000 of an offering. This raises two issues: (1) what is an offering; and (2) what payments count in calculating payment of $150,000? There is no distinc-

tion between the consideration paid by a natural person or an entity in determining if the $150,000 purchase price criteria has been satisfied. This aspect of Rule 501(a)(5) will be discussed in this Section II. The net worth analysis, however, is the same for corporations and trusts but different for partnerships. Therefore, the appropriate net worth calculation for each form of entity will be discussed individually in Sections III, IV and V of this article.

Several of the obvious applications of these principles were discussed in the release adopting Regulation D.[20] More subtle issues have been addressed in Questions 4 through 13 of the Interpretative Release,[21] as well as in several no-action letters issued by the SEC.

1. *What is an Offering?*

For real estate syndications, an issue that arises frequently is whether the $150,000 must be paid for a single security or for a combination of securities. Limited partnerships frequently offer a unit consisting of an equity ownership in the limited partnership combined with the limited partnership's note to the limited partner or other evidence of indebtedness secured by a mortgage on the partnership's underlying real property. The question is if the amounts paid by a purchaser for limited partnership interests can be aggregated with his purchase of notes in computing the $150,000 minimum.

The SEC has addressed a similar circumstance by concluding that where two issuers, a corporate general partner and the limited partnership of which it is the general partner, sell a package unit consisting of common stock and limited partnership interests, the purchase of $150,000 of such units would satisfy the $150,000 test.[22] The SEC's analysis stressed that the rule applies not to the securities of an individual issuer but rather to the securities of an offering. Since, under traditional securities law analysis concerning the integration of arguably separate transactions, the sale of the common stock and the partnership interest would be integrated,[23] the purchase of $150,000 of units represents purchase of $150,000 of an offering. By analogy, therefore, it seems clear that when an investor purchases both a limited partnership interest and a debt security from a limited partnership, the issues would be integrated and the purchase prices combined in calculating the amount paid in the offering.

2. *How do you Calculate the Payment of $150,000?*

An issue which arises frequently in the context of offerings where the subscription price is paid in installments is whether calculation of the $150,000 includes payment of principal only or principal and interest. The question, historically, affected only private offerings. With the recent passage of Rule 3a12-9, however, permitting publicly registered securities to be paid for in installments under certain circumstances,[24] the answer now impacts a significantly larger number of securities transactions.

Unfortunately for issuers seeking to expand the class of $150,000 purchasers, the SEC's position is that only principal payments can be included in the purchase price.[25] Amounts paid as interest, points or other costs associated with borrowings or installment payments are excluded in calculating if an investor purchased $150,000 of the securities being offered.

An additional aspect of Rule 501(a)(5) that has generated extensive commentary is the concept that the obligation to pay must be "unconditional." The Interpretative Release confirms that the term is, in fact, an absolute. When the purchase price is paid partly in cash and partly by a standby letter of credit which will not necessarily be drawn against, the amount of the standby letter of credit must be excluded in computing the $150,000 limit.[26] It is uncertain that the money will be paid and, therefore, the investor's obligation is not unconditional. Similarly, a voluntary, contingent and non-recourse assessment in an oil and gas program cannot be included in a purchaser's payment calculation because such an assessment is not deemed to be an unconditional obligation to pay.[27]

By contrast, certain assessments may be included. Where an investor in a Regulation D offering for an oil and gas drilling program commits to pay subsequent assessments and such payments are mandatory, non-contingent and bear personal liability, the assessments to be made within five years from the issue date are treated as a portion of the purchase price. In essence, the mandatory assessment is treated as an installment payment of principal.[28]

C. Rule 501(a)(8)

Rule 501(a)(8) is available to corporations, partnerships and trusts and provides that, to the extent that all of the equity owners of an entity are themselves accredited investors, the entity is accredited. The principal interpretative problems are identifying the equity owners of the entity and determining whether they are accredited investors under any of the provisions of Rule 501(a)(1), (2), (3), (4), (5), (6) or (7). The application of Rule 501(a)(8) to corporations, partnerships and trusts will be considered separately in Sections III, IV and V of this article.

III. Corporations

The treatment of corporations as accredited investors is extremely limited. Corporations for profit can be accredited investors only if: (1) they satisfy the conditions of Rule 501(a)(5) and are, therefore, qualified $150,000 purchasers; or (2) all of the shareholders of the corporation (i.e., the equity owners) are accredited investors and thus the corporation is an accredited investor pursuant to Rule 501(a)(8).

A. Corporations as $150,000 Purchasers

As discussed above, to qualify as an accredited investor under Rule 501(a)(5), investors must satisfy minimum purchase price and net worth standards. No questions arise when the purchasing corporation itself has a net worth sufficient to satisfy the rule. But corporations with affiliated groups and parent-subsidiary relationships pose different questions. Fortunately, the SEC has taken a consistent and philosophically sound approach to the primary interpretative issues which have arisen with respect to computation of corporate net worth. The policy analysis contained in two early no-action letters[29] was subsequently confirmed in Question 19 of the Interpretative Release.

In SEC No-Action Letter, Cardinal Financial Management Corp., a venture capital limited partnership, wanted to treat the Industrial Commission of the State of Ohio, acting for the Ohio State Insurance Fund, as a $1,000,000 purchaser. Since the purchase price easily satisfied the $150,000 minimum contained in Rule 501(a)(5), the narrow issues presented were: (1) whose net worth should be used for the net worth calculation (the record owner, i.e., the Industrial Commission of the State of Ohio or the beneficial owner, i.e., the Ohio State Insurance Fund); and (2) what is the net worth of an insurance fund?

The SEC concurred with the issuer that the relevant net worth was that of the beneficial owner, the State Insurance Fund. Since the State Insurance Fund had a surplus of $258,162,000 and the SEC treated the surplus as the equivalent of net worth, the purchase of a $1,000,000 limited partnership interest clearly represented less than 20% of the purchaser's net worth.

The issuer raised some additional and novel points, accurately noting that "the concept of net worth is not readily applicable to entities which have beneficiaries as opposed to shareholders or other equity owners." The issuer urged consideration of a far more expansive net worth test:

> ...[T]his surplus or fund balance represents only a part of what should properly be considered to be equivalent to the net worth of the State Insurance Fund or similar funds for purposes of Securities Act Rule 501(a)(5). As noted above, the surplus of fund balance of the State Insurance Fund represents the total assets of the Fund less (i) actual liabilities, and (ii) reserves for payment of insurance claims. Since such insurance reserves are an actuarial estimate of the amounts contingently owed to the beneficiaries of the State Insurance Fund, it would seem to be inconsistent with the purpose of the Securities Act Rule 501(a)(5) to deduct such reserves from total assets in determining the equivalent of the Fund's net worth. Rather we believe that 'net worth' as used in Rule 501(a)(5) should be interpreted in the context of a fund such as the State Insurance Fund to be equivalent to the net assets of the fund—that is, the total assets of the Fund less actual liabilities but without deducting reserves for payments to the beneficiaries of the Fund. Based upon this interpretation, the equivalent net worth of the State Insurance Fund would be $3,132,162,000.

Presumably because under the facts presented reference to this argument was unnecessary, the SEC granted the issuer's no-action request without responding to this analysis. As a consequence, the interpretative advice offers little guidance for the appropriate net worth analysis for this form of entity.

The facts of SEC No-Action Letter, Federated Financial Corp., represented more typical issues impacting a broad range of corporate purchasers. The issuer's no-action letter request sought confirmation that a wholly owned service corporation subsidiary could combine its net worth with its parent savings and loan association for purposes of the 20% net worth test. Among the arguments advanced in support of this position was reference to treatment of natural persons under Rule 501(a)(5), which permits the net worth of spouses to be combined. By analogy, the relationship of parent and subsidiary is equally close from a financial perspective, and consolidation of their net worth appears to be a consistent treatment of related persons. What may have been an even more persuasive insight, however, was that although the direct investor (the subsidiary) individually lacks the net worth necessary for accredited investor status, the parent corporation clearly "assumes the ultimate risk of loss in such an investment." Therefore, if the theoretical basis for accredited investor status is sufficient net worth and financial sophistication to bear the risk of loss (a traditional Section 4(2) approach), then viewing the parent corporation as the ultimate purchaser is consonant with the legislative and regulatory goals.

The staff granted the no-action position requested and concluded that the issuer could consider the consolidated net worth of a parent savings and loan association in determining that its wholly-owned subsidiary is an accredited investor. In Question 19 of the Interpretative Release,[30] the SEC reaffirmed that for purposes of the 20% net worth test under Rule 501(a)(5) a totally held subsidiary can use the consolidated net worth test of its parent in calculating whether its total purchase price exceeds 20% of its net worth.

B. Corporations as Rule 501(a)(8) Accredited Investors

Under Rule 501(a)(8), a corporation will only be an accredited investor if all of its equity owners are themselves accredited investors. For most corporations this means that all of the corporation's common shareholders must qualify while holders of pure debt securities could be non-accredited investors. More difficult interpretative questions will arise, however, if the corporation has more sophisticated securities with features common to both debt and equity securities. It is hard sometimes to properly classify preferred stock or certain forms of convertible debt as either debt or equity. An issuer has to carefully examine the capitalization structure of a corporate purchaser to determine who are the actual equity owners for purposes of Regulation D.

The limitations already discussed with respect to corporations, partnerships and trusts as accredited investors severely circumscribe the availability of Rule

501(a)(8) to many corporations. When the corporation's shareholders are natural persons, they can be accredited investors under Rules 501(a)(6) and (a)(7) and permit the corporation to qualify as an accredited investor. However, if the corporation has even a single shareholder which is a corporation, partnership or trust, ordinarily the corporation will not be able to avail itself of accredited investor status. A shareholder entity will only be an accredited investor if it, in turn, is wholly owned by accredited investors, a result apparently permitted under the partnership provisions and presumably available to corporations as well. *See*, Section IV(C) hereof. The fact that corporations with corporate shareholders will in ordinary circumstances not qualify as accredited investors under Rule 501(a)(8) invites a discussion of the fundamental unfairness of not having income or net worth tests for entities comparable to those of natural persons.

C. Why isn't IBM an Accredited Investor?

* What is perhaps most notable about corporations as accredited investors is that for most purposes, corporations are not accredited investors, a result clearly intended by the drafters of Regulation D. In the Interpretative Release, in response to Question 20, the staff noted that a corporation with a net worth of $2,000,000 was not an accredited investor because the $1,000,000 net worth test under Rule 501(a)(6) "is limited to natural persons."[31]

It is difficult to fathom the logic behind the SEC's disparate treatment of natural persons and entities. A natural person with a joint net worth (with his spouse) equal to or greater than $1,000,000 is an accredited investor. Yet a corporation with a net worth of $1,000,000 (or $5,000,000,000) is not an accredited investor, unless all of its shareholders are accredited investors. The larger the corporation the less likely it is to be held solely by accredited investors. Major public companies with vast financial and management capabilities are owned by a broad spectrum of investors. Thus, when a corporate giant like IBM participates in a Regulation D offering, IBM is treated as a non-accredited investor because all of its shareholders are not accredited. As a consequence, the offering cannot reap the benefits of being limited to solely accredited investors unless IBM purchases at least $150,000 of the offering and otherwise satisfies Rule 501(a)(5).

It is irrefutable that corporations with certain minimum net worths and/or income possess the same or greater leverage with an issuer as a bank, insurance company, pension plan or wealthy individual. It is past time for the SEC to recognize this self-evident reality, eliminate this anomaly and provide appropriate income and net worth tests, the satisfaction of which will enable a corporation to qualify directly as an accredited investor independently of Rules 501(a)(5) and 501(a)(8). Certainly the easiest way to accomplish this is by expanding the classification of persons eligible under Rules 501(a)(6) and (a)(7) to include corporations, partnerships and trusts.

IV. Partnerships

The circumstances under which partnerships can be accredited investors are essentially parallel to those of corporations. A partnership can achieve accredited investor status: (1) by qualifying as a $150,000 purchaser pursuant to Rule 501(a)(5); or (2) if all of the partnership's partners are themselves accredited investors as provided in Rule 501(a)(8). In addition, any general partner of a general partner of an issuer is an accredited investor in accordance with Rule 501(a)(4).

A. General Partners of a General Partner of an Issuer

A frequent vehicle in real estate programs involves a general partnership formed to serve as a general partner of syndicated real estate limited partnerships. The individual partners of such partnership may, or may not, separately qualify as accredited investors. Rule 501(a)(4) deems such persons to be accredited investors and reflects an administrative position that such partners, because of their involvement in management and assumed access to the financial and business information required to make an informed investment decision, should qualify as accredited investors. This approach is consistent with general case law analysis of suitable offerees in a traditional Section 4(2) statutory private placement. This regulatory flexibility was one of the significant clarifications effected by Regulation D.

B. Partnerships as $150,000 Purchasers

Whether a partnership has purchased $150,000 of the securities being offered is determined by reference to the standard rules discussed *supra* in Section II(B). Whether the amount invested exceeds 20% of the partnership's net worth, however, can be computed either with reference to: (1) the actual net worth of the partnership as an entity; or (2) for an existing investment partnership, the combined net worth of all of the partners. The alternative computations reflect a long-standing legal ambivalence as to whether a partnership is an entity or an aggregate.[32] Somewhat surprisingly, the SEC's interpretative positions have accepted the aggregate theory in a manner beneficial to issuers and prospective purchasers.

1. *Smith Barney*

The earliest interpretation of the aggregate approach under Regulation D[33] is contained in SEC No-Action Letter, Smith Barney, Harris Upham & Co.[34] The author of the no-action request represented that limited partnership interests would be purchased by investment general partnerships and expressed his opinion that such investment partnerships constituted single purchasers.[35] The interpretative question, however, was whether the aggregate net worth of the partners

could be used for computing that the purchase price was less than 20% of the net worth of the partnership.

Two excellent theories were advanced in support of this position. First, although an investment partnership constitutes a legal entity, on a practical analysis, it is a mere "pass through" vehicle for its partners. Because state law normally provides that general partners are liable for all debts and liabilities of a general partnership, the net worth of each general partner is exposed to the risk of partnership investments to the same extent as if the individual bought the securities directly.

The second basis urged to support the request was that the SEC recognize that investment partnerships generally do not maintain significant net worths. Compliance with Rule 501(a)(5) could be artifically created, however, by the simple expedient of having each partner contribute demand notes to the investment partnership immediately prior to the purchase to increase the partnership's net worth. The notes could then be withdrawn (or distributed) immediately after the purchase. The unambiguous language of Rule 501(a)(5) means that the net worth calculation is computed only at the time of sale and, therefore, a reduction in net worth subsequent to the sale of a security would not adversely affect the purchaser's accredited investor status as of the date of sale. While this argument has some appeal, a conservative issuer would heed the cautionary language of Preliminary Note 6 to Regulation D which notes that:

> "[i]n view of the objective of these rules and the policies underlying the Act, Regulation D is not available to any issuer for any transaction or chain of transactions that, although in technical compliance with these rules, is part of a plan or scheme to evade the registration provisions of the Act. In such cases, registration under the Act is required."

The sort of artificial satisfaction of the rules envisioned by a note contribution and subsequent redistribution is inherently suspect.

For whatever reason, the staff did not respond to the highly technical theory but did grant the no-action request based on the pass-through analysis. The SEC stated that it was of the view that the aggregate net worth of the general partners of an investment partnership may be considered in determining whether the investment partnership is an accredited investor under Rule 501(a)(5).

2. *DEF Fund*

The facts contained in SEC No-Action Letter, DEF Fund (the "Fund"),[36] are unusual but the principles and analysis involved, as well as the staff's interpretative advice, may be potentially illustrative in some situations.

The Fund is a general partnership organized by the partners of a law firm to serve as an investment vehicle. Under applicable state law, each partner is jointly and severally liable for each of the Fund's obligations. All partners do not

participate in each investment and may make an individual decision to invest or not to invest in any particular offering. All economic and tax incidents connected with each investment are allocated to the participating partners *pro rata* in accordance with their respective committed capital. All investments are made exclusively by the Fund, which was not organized for the specific purpose of acquiring securities in connection with any particular investment. Finally, to increase liquidity, each partner in the Fund can transfer his interest in the Fund to other partners in the Fund.

Based on the foregoing, the staff affirmed both positions taken by the Fund. First, the Fund could be treated as a single purchaser under Rule 501(e)(2). Second, for purposes of Rule 501(a)(5), the combined net worth of the general partners could be used to satisfy the 20% net worth test.

It is difficult to reconcile the SEC's position with either its answer to Question 59 of the Interpretative Release or the apparent intent of Rule 501(e)(2). In Question 59, the SEC dealt with an investment partnership, at least some of whose partners were not accredited. The partnership had been organized two years earlier and had invested in several transactions. The partners had individually reviewed the disclosure documents associated with each securities offering. After such review, all partners had not participated in each of the prior purchases.

In its answer, the SEC stressed a literal interpretation of Rule 501(e)(2) and concluded that the investment partnership could not be treated as a single purchaser. The analysis emphasized that because individual partners choose whether to purchase or not purchase on a transaction-by-transaction basis, effectively the partnership is reorganized with respect to each investment. Therefore, even though the legal entity effecting the purchase is a long-standing, pre-existing partnership, a closer factual analysis reveals that substantively a new entity has been formed for the purpose of acquiring each particular security. Accordingly, the issuer must disregard the entity and look to each individual partner as a purchaser.[37]

The facile distinction to be drawn between the earlier investment partnership situations, Question 59 and the Fund, is simply that the Fund was a general partnership while prior no-action letters dealt with limited partnerships. Question 59 does not specify that the investment partnership was either a general or limited partnership. If one concludes, based on the situations referenced in Question 59, that the SEC's intent was that the investment partnership referred to therein was a limited partnership, then the seemingly inconsistent positions taken therein and in DEF Fund become somewhat easier to reconcile.

Philosophically, however, the differences between a general or limited partnership, which primarily relate to limitations on liability, should be irrelevant. The appropriate inquiry is whether the partnership was formed (or reformed) for the purpose of acquiring a specific security. In the case of the Fund, different partners made individual choices based on information provided for each investment. Irrespective of whether such investors purchased a security through an existing

general partnership or technically formed a new general partnership, it would still seem that specific people have banded together to make an investment decision. Based on all of the SEC's other positions, that would seem to dictate a conclusion that the issuer should disregard the entity and include all of the underlying Fund participants in this investment as a purchaser.

If the Fund stands as a model of an acceptable investment partnership for Regulation D purposes, it provides a flexible and responsive vehicle for potential investor groups. The mode offers flexibility on investment decisions, ability of non-accredited investors to aggregate economic power to become $150,000 purchasers and thereby achieve accredited investor status, use of combined net worth, and a degree of liquidity in otherwise illiquid investments. Because of the complexity of the facts involved, as well as the sophistication level of the Fund and its participants, it cannot be assumed that the SEC would reach a comparable conclusion for less sophisticated investor groups.

There are, however, drawbacks to the Fund approach. Each partner in a general partnership has joint and several liability for each investment, even when the partner is not a participant in that investment. This theoretical problem can be substantially negated if the investment partnership invests only as a shareholder or limited partner so that liability is limited to the capital invested. The investment partnership agreement can also provide for indemnification by participating partners of those participants not investing in a specific transaction. As a general rule, it would seem that the most likely use of the Fund as a model would be situations where individuals with a long-standing business relationship (i.e., shareholders in a closely held business or professionals in an association) desire to establish an affiliate entity for investment purposes in essentially passive transactions.

C. Partnerships as Rule 501(a)(8) Accredited Investors

Because entities are frequently partners in partnerships, Rule 501(a)(8) would apply in many situations if the issuer can look through its first-tier partners to their beneficial owners. In this manner, a partnership could be an accredited investor if its entity partners were wholly owned by accredited investors. Fortunately, the SEC took precisely that posture in SEC No-Action Letter, Television Station Partners.[38]

The partnership which sought status as an accredited investor (the "Buyer") was a general partnership whose partners covered the full array of natural persons and entities. Two of the Buyer's partners were natural persons, accredited investors under Rules 501(a)(6) or (a)(7). Two of the partners were corporations, all of the shareholders of which were accredited investors under Rules 501(a)(6) or (a)(7). Two of the Buyer's partners were revocable grantor trusts, all of the grantors of which were accredited investors under Rules 501(a)(6) or (a)(7). One of the Buyer's partners was itself a general partnership (the "Second Tier Partnership"), two of the general partners of which were natural persons

accredited under Rules 501(a)(6) or (a)(7), and five of the partners of which were revocable grantor trusts having grantors that were accredited under Rules 501(a)(6) or (a)(7).

No issues are raised under Rule 501(a)(8) by the two individual partners who were accredited investors under the rules relating to natural persons or the revocable grantor trust. The trust was an accredited investor because all its trustees were accredited investors. *See*, discussion *infra*, Section V.

With respect to the corporate partner in the Buyer, it is only an accredited investor if the issuer can look through the first-tier partner, the corporation, to such corporation's shareholders. Since each of the corporation's equity owners is, in turn, a natural person who is an accredited investor, the staff agreed that the corporation is an accredited investor by application of Rule 501(a)(8).

The same veil-piercing exercise is both required, and permitted, with respect to the Second Tier Partnership. The partners in the Second Tier Partnership consisted of two natural persons, each of whom was an accredited investor, and five revocable grantor trusts, all of the grantors of which were accredited investors. By employing a flow-through analysis, the Second Tier Partnership was accredited under Rule 501(a)(8) because each of its partners was accredited. The Buyer, therefore, was accredited because all of its equity owners — the natural persons, corporation, revocable grantor trusts and the Second Tier Partnership — were accredited investors. This is a logical and important interpretation of Rule 501(a)(8) which delineates the extent of availability of the Rule to both corporations and partnerships.

D. Traps for the Unwary

Numerous situations arise, typically in the context of estate planning, where partnerships are created specifically for the purpose of acquiring a particular security. The partnership is, therefore, clearly subject to the general prohibitions of Rule 501(e)(2) which states that each beneficial owner of the entity shall count as a separate purchaser for all provisions of Regulation D.

A frequent and incomplete approach to accommodate the stated goals of the accredited investor is the establishment of a partnership, either general or limited, where the accredited investor is either the managing partner of a general partnership or the general partner of a limited partnership. The spouse and children (all of whom share the principal residence of the accredited investor) are the other general partners of the general partnership, or more typically, the limited partners of the limited partnership.

The issuer's analysis, however, proceeds as follows. The spouse of the accredited investor is an accredited investor based on the spousal relationship.[39] The children, the issuer believes, are accredited investors based on the family relationship and should be excluded from the calculation of the number of purchasers based on Rule 501(e)(1)(i). Therefore, even though the partnership is newly formed, there are no non-accredited investors and accordingly no purchasers.

The fallacy in this logic is twofold. First, it ignores the overriding mandate of Rule 501(e)(2). Because the partnership is newly formed, the exclusionary provisions of Rule 501(e)(1)(i) are not available to the issuer. Second, only the spouse of an accredited investor is an accredited investor — not children. Therefore, while the accredited investor and spouse do not constitute purchasers, each child will be counted as a non-accredited investor.

If the partnership were pre-existing, then the related persons would not be included in the determination of the 35 non-accredited investor limitations[40] but would be counted for all other Regulation D purposes, including information disclosure requirements. The issuer can thus face an anomaly. In an offering to only accredited investors and their children, there are no purchasers for certain Regulation D purposes since accredited investors are not counted as purchasers and their children are likewise excluded from the calculation of the number of purchasers under Rule 501(e)(1)(i). Yet, since the children are non-accredited investors, full disclosure of information is required since non-accredited investors are purchasers!

V. Trusts

As a general rule, a trust can qualify as an accredited investor only if: (1) it qualifies as a $150,000 purchaser under Rule 501(a)(5);[41] or (2) a bank which is an accredited investor under Rule 501(a)(1) serves as the trustee of the trust.[42] While this describes the limited options available to conventional trusts, certain revocable grantor trusts can also achieve accredited status under Regulation D.

A. Trusts as $150,000 Purchasers

The calculation of whether a trust is purchasing $150,000 of the securities of the offering is determined in accordance with the normal rules discussed in Section II(B) of this article.

The net worth computation is consistent with corporate analysis. The trust is viewed as an entity — separate and distinct from its trustees and beneficiaries. That perception leads to two corollaries. Except where a bank is a trustee, the fact that one or more of the trustees of a trust are accredited investors does not result in the trust being an accredited investor.[43] Second, the fact that all the beneficiaries of a conventional trust are accredited investors does not make the trust an accredited investor under Rule 501(a)(8). Although the rule grants such status to any entity all of whose "equity owners" are accredited, the beneficiaries are not treated as the equity owners of the trust. The relevant net worth of a trust for purposes of Rule 501(a)(5) is that of the trust itself without reference to the net worth of the trustees, the beneficiaries of the trust or any affiliated entities.[44]

B. Revocable Grantor Trusts as Rule 501(a)(8) Accredited Investors

The staff has consistently adhered to the view that a revocable grantor trust is an accredited investor where the grantors of the trust are all accredited investors.[45] Since the typical revocable grantor trust is created by spouses, if the two of them have a combined net worth of $1,000,000 or more or either of them qualifies for the $200,000 per year income test, then accredited investor status will be achieved by each of them.

The analysis stems from the staff's perception that the equity owners of a revocable grantor trust are the grantors. This position is sound when the terms of the trust expressly provide that the trust may be amended, and more significantly, revoked, at any time by the grantors. Thus, the ultimate risk of loss is borne by the grantors of the trust and the existence of the trust may be disregarded for securities analysis.[46]

The earliest of the trust no-action letters, Lawrence S. Rabkin, Esq., dealt with one of the most common trust situations for a real estate syndication — a revocable family trust. As is characteristic of such trusts, the trust agreement provides that the trust can be amended or revoked by joint action of the grantors during their lifetime. After the death of the first grantor, the survivor can amend or revoke the trust. Because of the control retained by the grantors, the Internal Revenue Service has taken the position that the tax benefits of investments made by such a trust accrue to the grantors rather than to the trust. As a consequence, high income tax bracket taxpayers who wish to facilitate the distribution of their estate establish revocable family trusts. This permits them to retain the tax benefits of the investment while providing for the cash flow and ultimate cash proceeds from sale or refinancing to flow into the trust.

The SEC staff concurred in the analysis that the grantors of a revocable family trust are its equity owners. Therefore, if the grantors are accredited investors, the trust will qualify as an accredited investor under Rule 501(a)(8).

A more unconventional trust, but which possessed many of the attributes of a revocable grantor trust, was the subject of SEC No-Action Letter, Herbert S. Wander.[47] The trust was irrevocable — thereby superficially distinguishing it from a revocable grantor trust. The operation of certain provisions of the trust documents, however, resulted in an entity with control elements, risk of loss and federal income tax features strongly resembling a revocable grantor trust. The staff was persuaded that the trust should be granted accredited investor status based upon the accredited investor status of the grantor of the trust.

In particular, the trust had the following features: first, the trust, which was irrevocable, was established by the grantor (an accredited investor) for family estate planning purposes. Second, the trust was a grantor trust for federal income tax purposes. Third, during the first 15-year period following the investment: (1) all of the assets of the trust would be includable in the grantor's estate for federal estate tax purposes in the same manner as if the grantor had made the investment himself; and (2) the grantor would be taxed on all trust income of the trust during at

least the first 15 years following the investment and would be taxed on any sale of trust assets during that period. Fourth, the entire amount of the grantor's contribution to the trust plus a fixed rate of return on the contribution would be paid to the grantor (or his estate) before any payments could be made to the beneficiaries of the trust. Finally, the grantor was a co-trustee with sole investment discretion on behalf of the trust at the time the investment was made.

The staff affirmed that the trust was an accredited investor but not for the reasons originally requested. The original letter[48] posited that the trust should be treated as an accredited investor under Rule 501(a)(6), which by its terms applies only to natural persons, because the trust was indistinguishable from its grantors. The author of the request argued that the grantor: (1) makes the investment decision; (2) is treated as the owner of the investment for federal income and estate tax purposes for a minimum of 15 years; and (3) bears the economic loss of the investment during such period. Accordingly, the trust effectively did not exist for virtually all purposes and the accredited investor status of the trust should be determined by reference to the grantor's status.

In a second letter to the SEC, the author advanced a separate analysis for concluding that the trust was accredited. For most of the reasons advanced above, the grantor should be deemed to be the equity owner of the trust. The SEC's normal position is that neither the trustee nor the grantor is the equity owner of a conventional trust. Under the circumstances of this trust, however, the SEC was persuaded that the accredited investor grantor should be treated as the sole equity owner of the trust. Therefore, the trust was treated as an accredited investor under Rule 501(a)(8) since all of its equity owners were accredited investors.

VI. Conclusion

In general, the treatment of corporations, partnerships and trusts as purchasers under Rules 501(a)(5) and (a)(8) of Regulation D is fair and consistent. The statutory language is clear and the SEC has done an excellent job of interpreting the ambiguities and interpretative issues which have arisen. The one major inequality, however, must be dealt with. Specifically, the SEC must amend Rule 501 so as to enable corporations, partnerships and trusts to attain accredited investor status based upon their income and net worth. While one can disagree about whether the threshold net worth and income figures for such entities should be identical to or higher than those of natural persons, it is inescapable that there is nothing intrinsic to entity form that should deny it that status. To the same effect, a regulatory system that permits a Code Section 501(c)(3) organization with sufficient assets to be an accredited investor, while denying that classification to IBM, cannot be justified and should not be further condoned.

REFERENCES

1. Regulation D was adopted effective April 15, 1982. SEC Release No. 33-6389. The Rules rescinded prior Rules 146, 240, and 242 and replaced them with new Rules 506, 504, and 505, respectively. For articles discussing aspects of Regulation D generally, *see*, Donahue, "New Exemptions from the Registration Requirements of the Securities Act of 1933: Regulation D," 10 *Sec. Reg. L.J.* 235 (1982); Ellsworth and Montelepre, "Use of Solicitations of Interest and Similar Pre-Offering Documents Prior to a Private Placement," 5 *Real Est. Sec. J.* 68 (1984); Powers, "Regulation D Offerings of Real Estate Syndication Interests: An Update," 3 *Real Est. Sec. J.* 38 (1982); Warren, "A Review of Regulation D: The Present Exemption Regimen for Limited Offerings Under the Securities Act of 1933," 33 *Am. U.L. Rev.* 355 (1984); Wertheimer, "Federal Limited Offering Exemptions: Regulation D and Recent Interpretations," 14 *Inst. on Sec. Reg.* 15 (1983); Note, "Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933," 24 *Wm. and Mary L. Rev.* 121 (1982).
2. 17 C.F.R. 239.501. Rule 501 delineates definitions, terms, and conditions which apply to all of Regulation D.
3. 17 C.F.R. 239.502. Rule 502 establishes prerequisites relating to all exemptions under Rules 504, 505, and 506. In general, Rule 502 deals with principles of integration of otherwise separate offerings under Regulation D, specified disclosure requirements, limitations on general advertising and solicitation in connection with an offering, and certain restrictions on the resale of securities acquired in a Regulation D offering.
   For articles discussing the issue of integration under Regulation D, *see*, Note, "Integration of Securities Offerings: Report of the Task Force on Integration," 41 *Bus. Law.* 595 (1986); Note, "Integration of Partnership Offerings: A Proposal for Identifying a Discrete Offering," 37 *Bus. Law.* 11591 (1982). For an excellent article discussing certain of the problems with disclosure obligations under Regulation D, *see*, Robinson, "Disclosure in Private Offerings: How Much is Enough?" 6 *Real Estate Sec. J.* 61 (1985).
4. 17 C.F.R. 239.503. Rule 503 outlines the mechanics of filing Form D with the SEC, and enumerates the information to be contained therein.
5. Compliance with Regulation D exempts an issuer from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"). It does not, however, exempt the issuer from compliance with the antifraud provisions of the Securities Act or the applicable state registration or antifraud provisions.
   Although the states have made progress in adopting the Uniform Limited Offering Exemption which, in effect, creates an exemption from state registration for securities exempt under Regulation D, universal adoption of the Uniform Limited Offering Exemption is still far from a reality. Numerous substantive variations in the basic statute have been adopted by the states,

including such basics as whether filing of state notifications must precede or follow the offer or sale of securities. Narrative and financial disclosure requirements also differ dramatically from state to state. As a consequence of these inconsistencies, an issuer must carefully scrutinize the requirements of each state in which offers or sales are to be made to insure compliance with applicable state securities laws.

6. 17 C.F.R. 239.504. Rule 504 is available for offerings up to $500,000.
7. 17 C.F.R. 239.505. Rule 505 is available for offerings not in excess of $5,000,000.
8. 17 C.F.R. 239.506. Rule 506 is available for all offerings, regardless of size. It is more predictable and easier to comply with than its predecessor, Rule 146, for several reasons. Wealth and sophistication standards apply only to purchasers, not to offerees, so that an offer to an unqualified investor does not, as it would have under Rule 146, destroy the availability of the exemption, provided that no sale is made to such an investor.
9. The calculation of the number of purchasers also excludes foreign investors. Preliminary Note 7 to Regulation D provides that:

   > Offers and sales of securities to foreign persons made outside the United States effected in a manner that will result in the securities coming to rest abroad generally need not be registered under the Act. *See,* Release No. 33-47098 (July 9, 1964) [29 FR 828]. This interpretation may be relied on for such offers and sales even if coincident offers and sales are made under Regulation D inside the United States. Thus, for example, persons who are not citizens or residents of the United States would not be counted in the calculation of the number of purchasers. Similarly, proceeds from sales to foreign purchasers would not be included in the aggregate offering price. The provisions of this note, however, do not apply if the issuer elects to rely solely on Regulation D for offers or sales to foreign persons.

   See, SEC No-Action Letter, American Real Estate 82-A ("non-U.S. citizens and residents may be excluded from the calculation of the number of purchasers under Rule 501(e) of Regulation D"). *See,* generally, Morgenstern, "Real Estate Securities and the Foreign Investor—Some Problems and a Proposal," 11 *Sec. Reg. J.* 332 (1984); Morgenstern, "Extraterritorial Application of United States Securities Law—A Matrix Analysis," 7 *Hastings Int'l and Comp. L. Rev.* 201 (1983).
10. 17 C.F.R. 230.501(e)(2).
11. *Id.*
12. The release adopting Regulation D, noted as follows, in Section II(A) thereof:

    > . . . Rules 504 and 505 replace Rules 240 and 242, respectively, and provide exemptions from registration under Section 3(b) of the Securities Act. Rule 506 succeeds Rule 146 and relates to transactions that are deemed to be exempt from registration under Section 4(2) of the Securities Act.

13. 17 C.F.R. 230.502(c). The rule provides, in full, that:

    (c) *Limitation on manner of offering.* Except as provided in §230.504 (b)(1), neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising, including, but not limited to, the following:

    (1) Any advertisement, article, notice or other communication published in any newspaper, magazine or similar media or broadcast over television or radio; and

    (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.
14. There is a single, narrow exception to this principle. Rule 504(b)(1) provides that Rule 504 offerings conducted where all offerees must receive disclosure documents pursuant to the registration requirements of all states involved is not subject to the prohibitions of Rule 502(c).
15. SEC No-Action Letter, Hall Moneytree Associates Limited Partnership (November 3, 1983). The SEC agreed that an existing limited partnership which intended to solicit management employees of Hall Real Estate Group was a single purchaser when the primary purpose of the partnership was to make investments in limited partnership interests of affiliated programs, even though at the time of solicitation the partnership was considering making purchases in five identified investments. The SEC has also concluded that an investment partnership should be considered to be a single purchaser for purposes of Regulation D in SEC No-Action Letter, DEF Fund (November 7, 1983), and for purposes of former Rule 146 in SEC No-Action Letter, Henry Crown Partnership (September 1, 1977). DEF Fund is discussed, *infra,* in Section IV(B)(2) hereof.
16. In addition, the issuer should address certain concerns raised by entities as purchasers not directly stemming from securities law concerns. The entity should also represent that the execution and delivery of the subscription documents have been duly and validly authorized, constitute the binding obligation of such entity, and do not violate any applicable state or federal law.
17. It should be noted that the information disclosure requirements are different under Rule 504 than pursuant to Rules 505 and 506. Regardless of the status of purchasers as accredited or non-accredited investors, Rule 502(b)(i) provides that:

    (i) If the issuer sells securities . . . under Rule 504 . . ., paragraph (b) of this rule does not require that specific information be furnished to purchasers.
18. Banks, insurance companies, registered investment companies and business development companies satisfying certain statutory definitions are accredited investors pursuant to Rules 501(a)(1) and 501(a)(2). Non-profit organizations within the meaning of Section 501(c)(3) of the Internal Revenue Code

with total assets in excess of $5,000,000 are accredited investors by virtue of Rule 501(a)(3). Rule 501(a) provides as follows:

(a) *Accredited investor.* "Accredited investor" shall mean any person who comes within any of the following categories, or who the issuer reasonably believes comes within any of the following categories, at the time of the sale of the securities to that person:

(1) Any bank as defined in Section 3(a)(2) of the Act, whether acting in its individual or fiduciary capacity, insurance company as defined in Section 2(13) of the Act, investment company registered under the Investment Company Act of 1940 or a business development company as defined in Section 2(a)(48) of that Act, Small Business Investment Company licensed by the U.S. Small Business Administration under Section 301(c) or (d) of the Small Business Investment Act of 1958, employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in Section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of $5,000,000;

(2) Any private business development company as defined in Section 202(a)(2) of the Investment Advisers Act of 1940;

(3) Any organization described in Section 501(c)(3) of the Internal Revenue Code with total assets in excess of $5,000,000 . . .

19. Rule 501(a)(5) provides in its entirety that an accredited investor includes:

(5) Any person who purchases at least $150,000 of the securities being offered, where the purchaser's total purchase price does not exceed 20 percent of the purchaser's net worth at the time of sale, or joint net worth with that person's spouse, for one or any combination of the following: (i) cash, (ii) securities for which market quotations are readily available, (iii) an unconditional obligation to pay cash or securities for which market quotations are readily available, which obligation is to be discharged within five years of the sale of the securities to the purchaser, or (iv) the cancellation of any indebtedness owed by the issuer to the purchaser.

20. SEC Release No. 6389 (March 8, 1982), [1981–1982 Transfer Binder,] Fed. Sec. L. Rep. (CCH) ¶83,106 at 84,913.

An investor whose net worth at the time of sale is $750,000 and who purchases $150,000 of the offering in cash on the day of sale is accredited. The same investor maintains that status if his payment is spread out over five years, so long as on the date of purchase he enters into an unconditional obligation to pay within that period. If, however, that investor agrees to purchase $200,000 of securities in installments, $150,000 to be paid on the date of sale and the balance in four years, he

will not qualify under this category of accredited investor because his total purchase of $200,000 is more than 20 percent of his $750,000 net worth. A final case involves the investor with a net worth of $900,000 who agrees to purchase $180,000 of securities over six years, the first $150,000 of that purchase coming in the first five years. That investor is accredited because he is purchasing at least $150,000 within a five year period and because the total purchase of $180,000 does not exceed 20 percent of his net worth.

21. In 1983, the SEC issued an interpretative release (the "Interpretative Release" in question and answer form, which posed 92 questions with respect to commonly raised issues arising under Regulation D. SEC Release 33-6455 (March 3, 1983).
22. Interpretative Release, Question No. 7.
23. For a discussion of the concept of integration, *see,* SEC Release No. 33-4552 (November 6, 1962). In general, the SEC's position is that whether separate issues must be integrated is determined by reference to the following five factors. Are the offers and sales: (1) part of a single plan of financing; (2) involving the issuance of the same class of securities; (3) made at or about the same time; (4) involving the same kind of consideration; or (5) made for the same general purpose?
24. The SEC adopted Rule 3a12–19 under the Securities Exchange Act effective March 7, 1986. The new rule permits broker-dealers to participate in public offerings of direct participation programs with mandatory installment provisions with certain specified limitations. In addition to the stipulation that the securities either be registered under the Securities Act or offered pursuant to an intrastate offering conducted in compliance with Section 3(a)(11) of the Securities Act, there are three additional requirements. First, the mandatory deferred payments must bear a reasonable relationship to the capital needs and program objectives described in a business development plan. Second, a minimum of 50% of the purchase price of the securities must be paid by the investor at the time the securities are sold. Finally, the total purchase price must be paid within three years in the case of specified property programs and two years in the case of non-specified property programs.
25. Interpretative Release, Question No. 8.
26. *Id.* Question No. 10.
27. *Id.* Question No. 12.
28. *Id.* Question No. 11.
29. SEC No-Action Letter, Cardinal Financial Management Corp. (May 31, 1982); SEC No-Action Letter, Federated Financial Corp. (June 1, 1982).
30. Interpretative Release, Question No. 19 states as follows:
    Question: A totally held subsidiary makes a cash investment of $200,000 in a Regulation D offering. May that subsidiary use the consolidated net worth of its parent in determining whether or not its total purchase price exceeds 20 percent of its net worth?

Answer: Yes.
The reference to a "totally held subsidiary," rather than the "wholly-owned subsidiary" concept found in the Federated No-Action Letter, is based on the definition of a "totally held subsidiary" contained in 17 C.F.R. 230.405.

31. The subprovision specifically provides that the then accredited investor includes "[a]ny *natural* person whose individual net worth, or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000." [Emphasis added.]
32. For an excellent article discussing this issue with respect to the Uniform Partnership Act, *see,* Jensen, "Is a Partnership Under the Uniform Partnership Act an Aggregate or an Entity?" 16 *Vand. L. Rev.* 377 (1963).
33. For the value of historical perspective, certain no-action letters issued in response to inquiries under Rule 146 may offer some guidance. *See,* SEC No-Action Letter, Kenai Oil & Gas, Inc. (March 27, 1979). [If a limited partnership amended its limited partnership agreement to permit a voluntary assessment, the proceeds of which would be used to purchase securities of an affiliate limited partnership, the situation would be "tantamount to a reorganization" for the specific purpose of acquiring securities and, therefore, the partnership could not be counted as one purchaser. Each beneficial owner of equity interests would count as a separate purchaser]; SEC No-Action Letter, Henry Crown Partnership (October 3, 1977). [A general partnership formed for the purpose of acquiring securities, which was formed when no specific investments had been earmarked, should be considered a single purchaser for purposes of Rule 146(g)(2)(ii).]
34. SEC No-Action Letter, Smith Barney, Harris Upham & Co. (July 14, 1982). The advice given therein was confirmed in Question No. 18 of the Interpretative Release, which provided as follows:
    Question: An investment general partnership is purchasing securities in a Regulation D offering. The partnership was not formed for the specific purpose of acquiring the securities being offered. May the issuer consider the aggregate net worth of the general partners in calculating the net worth of the partnership?
    Answer: Yes. An investment general partnership is functionally a vehicle in which profits and losses are passed through to general partners and in which the net worths of the general partners are exposed to the risk of partnership investments.
35. Each investment partnership would be an existing general partnership formed for the purpose of making investments of a type which includes, but may not be limited to, investments in limited partnerships. More importantly, perhaps, the partnerships would not be "formed or reformed" for the specific purpose of acquiring the particular units being offered. This latter representation was presumably made to avoid certain of the issues raised in SEC No-Action Letter, Kenai Oil & Gas, Inc.
36. SEC No-Action Letter, DEF Fund (December 7, 1983).

37. The SEC's footnote reference indicated that this interpretation was consistent with prior interpretations under Rule 146. *See,* SEC No-Action Letter, Madison Partners Ltd. 1982-1 (January 18, 1983); SEC No-Action Letter, Kenai Oil & Gas, Inc. (April 27, 1979).
    Question No. 59 provides, in full, that:
    Question: An investor in a Rule 506 offering is an investment partnership that is not accredited under Rule 501(a)(8). Although the partnership was organized two years earlier and has made investments in a number of offerings, not all the partners have participated in each investment. With each proposed investment by the partnership, individual partners have received a copy of the disclosure document and have made a decision whether or not to participate. How do the provisions of Regulation D apply to the partnership as an investor?
    Answer: The partnership may not be treated as a single purchaser. Rule 501(e)(2) provides that if the partnership is organized for the specific purpose of acquiring the securities offered, then each beneficial owner of equity interests should be counted as a separate purchaser. Because the individual partners elect whether or not to participate in each investment, the partnership is deemed to be reorganized for the specific purpose of acquiring the securities in each investment. Thus, the issuer must look through the partnership to the partners participating in the investment. The issuer must satisfy the conditions of Rule 506 as to each partner.
38. SEC No-Action Letter, Television Station Partners (April 29, 1983).
39. Rule 501(a)(6) provides that the computation of net worth for natural persons includes the net worth of such person's spouse. Therefore, if one spouse is accredited based on the net worth provisions, then both are accredited.
40. Rule 501(e)(1)(i) provides that:
    For purposes of calculating the number of purchasers under § 230.505(b) and § 230.506(b) only, the following shall apply:
    (1) The following purchasers shall be excluded:
    (i) Any relative, spouse or relative of the spouse of a purchaser who has the same principal residence as the purchaser . . .
41. Interpretative Release, Question No. 27.
    Question: May a trust qualify as an accredited investor under Rule 501(a)(5)?
    Answer: Yes. The Division interprets "person" in Rule 501(a)(5) to include any trust.
42. *Id.* Question No. 26
    Question: May a trust qualify as an accredited investor under Rule 501(a)(1)?
    Answer: Only indirectly. Although a trust standing alone cannot be accredited under Rule 501(a)(1), if a bank is its trustee and makes the investment on behalf of the trust, the trust will in effect be accredited by virtue of the provision in Rule 501(a)(1) that accredits a bank acting in a fiduciary capacity.

43. *Id.* Question No. 29.
Question: A trustee of a trust has a net worth of $1,500,000. Is the trustee's purchase of securities for the trust that of an accredited investor under Rule 501(a)(6)?
Answer: No. Except where a bank is a trustee, the trust is deemed the purchaser, not the trustee. The trust is not a "natural" person.
44. The SEC has construed the trust analysis extremely narrowly. In SEC No-Action Letter, Gary P. Kreider, Esq. (October 26, 1984) the staff refused to permit a series of twelve, jointly administered irrevocable trusts, each with a net worth in excess of $5,000,000, to be treated as one person for purposes of computing a $150,000 purchase by an investor under Rule 501(a)(5). The trusts had: (1) a common source of funds from one settlor; (2) a set of beneficiaries with family relationships; (3) common trustees for all trusts; and (4) similar trust provisions for all trusts.
45. SEC No-Action Letter, Lawrence B. Rabkin, Esq. (August 16, 1982); SEC No-Action Letter, Television Station Partners (April 29, 1983); Interpretative Release, Question No. 30.
46. Substantially the same reasoning leads to the position that an Individual Retirement Account ("IRA"), of whatever size, whose participant is an accredited investor, is likewise an accredited investor. Clearly, the participant is deemed the equity owner of his IRA. Question No. 30 of the Interpretative Release provides, in part, that "where the purchase of Regulation D securities is made by an Individual Retirement Account and the participant is an accredited investor, the account would be accredited under Rule 501(a)(8)."
47. SEC No-Action Letter, Herbert S. Wander (November 25, 1983).
48. Letter from Herbert S. Wander, Esq. to SEC (September 2, 1983).