“Sophisticated Investors” – how to determine; by Bruce E. Methven

Several securities-offering exemptions allow “sophisticated investors” to invest. The question is how to determine when potential investors are sophisticated.

Federal Rule 506 offerings (and the California 25102(f) offering) allow a class of “sophisticated investors”, meaning sophisticated in terms of investments. “Sophisticated investor” means an investor who is either personally or with the help of an independent investment advisor able to make an intelligent decision about whether or not to invest in the offering. (The specific definition is “has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment”.)

Offering companies virtually always use an investor questionnaire to determine whether a potential investor is sophisticated. The questionnaire covers such things as prior investment experience, current investments, risk tolerance and the potential investor’s education and career. Top management of the offering company must review the responses and determine whether the investor is sophisticated. Management is entitled to rely on the responses unless it has reason to doubt them, in which case additional investigation must be made. (If the potential investor is using an investment advisor, the questionnaire also has a section asking for the contact information for that advisor.)

Companies often ask if “sophisticated investor” isn’t a fairly subjective term. It is. For example, an investor could be sophisticated for some types of investments and not for others. The safe course is to reject any potential investor where there is any doubt about whether that investor is sophisticated – or inform them that they must retain an independent investment advisor.

Any investment advisor must be independent of the offering company. That means that the company cannot pay for the investment advisor and the investment advisor must have no relationship with the company, such as being an officer, director, manager, employee or independent contractor of the company. Of course, the investment advisor must be sophisticated in terms of investments. The potential investor’s Uncle Bob who is a musician but occasionally invests in the commodities futures markets won’t qualify.

Accepting sophisticated investors is riskier than, for example, limiting the offering to only accredited investors. On the other hand, it can be accomplished if done with care and it is often the only way of raising all the money needed for an offering.

Bruce E. Methven

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Bruce E. Methven, 2232 Sixth Street Berkeley, CA 94710
Phone: (510) 649-4019; Fax: (510) 649-4024
www.TheCaliforniaSecuritiesAttorneys.com