## Jumpin' Jehoshaphat, alternative asset deal structures – ugh!

A bold headline, but let's review our own experiences and this note to see if we agree with it. However, not to be a negative Nellie, there is hope, which will be explored in the next edition. Alternative assets are significant, having grown 400% since 2010 and projected to be $17.2 trillion by 2025. These assets constitute a 50%+ portfolio allocation by ultra-high-net worth families (UHNW)*. First, we should examine the common approaches of Regulation D structures used to package these investments.

These structures generally use Rule 506 under Regulation D as a safe harbor from the Securities Act of 1933 to avoid Securities and Exchange Commission (SEC) registration and rely on exceptions under Sections *3(c)(1)* and *3(c)(7).* For this note, we will skip over the real estate focused *3(c)(5)*, a nifty, although an infrequently used, category. Seven touchstones to evaluate these structures and how they are implemented by sponsors/managers:

1. **Asset pricing – Sponsor/Manager Determined.** The investor must decide if the offered price makes investment sense, when it was determined, and the valuation methodology.

2. **Regulatory oversight – Modest,** while the SEC reviews can be painful to undertake, Reg D structures circumnavigate them as an exempt offering. There are virtually no requirements under Reg D as to what information must be provided to accredited investors. Yes, much lawyer input but no prophylactic oversight with its painfully derived benefits, i.e., you are on your own, meaning *caveat emptor*.

3. **Investor qualification – High or quite high,** limiting the audience of potential investors. Simplifying: Rule 506 generally requires individual investors to have net worth greater than $1 million excluding primary residence or income greater than $200K, or $300K jointly, in the last two years. No more than 100 investors with venture capital exceptions and additional criteria if there is an incentive fee. *3(c)(7)* generally requires individual investors to have $5 million or more in investments and $25 million for an entity. No more than 2000 investors.

4. **Offering size – Unlimited** and thus attractive.

5. **Liquidity – Low.** The sponsor/manager sets the bar, which generally permits only limited distributions and limited sales of equity. Furthermore, sale of the underlying assets is almost always determined by the sponsor/manager, not the investor.

6. **Investor Control – Low;** other than any pre-determined liquidity provision, e.g., for interest or dividend distributions, if offered. Typically, once invested, you are stuck unless and until the sponsor/manager decides otherwise. Again, the timing of asset sales is determined at the option of the sponsor/manager in almost all cases.

7. **Costs – Historically, High:** In many offerings, the sponsor/manager may mark up the asset, charge an annual management fee from 1-3% and a profit participation fee on asset disposition from 15-25% of any profit.

A short note cannot cover every detail or exception for pricing structure and deal specific terms, albeit the above notes provide a generalized overview.

**Disambiguation**

The picture painted highlights the investor challenges.

Like Lewis Carroll, the famous mathematician writer of *Through the Looking Glass*, our goal is to distinguish differences between similar things seeking clarity. In our next missive, we will unveil a revolutionary alternative to give investors:

1. True market price discovery
2. More regulatory oversight
3. Modest investor qualification requirements
4. Flexible offering size while more limited but still sizable
5. Greater liquidity
6. Enhanced control
7. Lower costs

Stay tuned please. Of course, all comments most welcomed.

* From Nasdaq and other research