



## FINANCIAL SERVICES COMMISSION

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### Discussion Paper: The Concept of “Qualified Investor” and its Importance to Jamaica’s Capital Markets

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#### Background

Mature capital markets such as that of the US and Canada as well as other jurisdictions recognize the significance of allowing the growth of a specialized market for the funding of small private companies, pooled investment funds and other types of investments that are not suitable for the general retail market. These jurisdictions permit this important capital formation to happen by allowing the sale of these investments to qualified investors or purchasers<sup>1</sup>. For example, in the US, section 3(c)(7) of the Investment Company Act of 1940 generally excludes from regulation any issuer whose securities are owned exclusively by "qualified purchasers."<sup>2</sup> For background, the Securities and Exchange Act and the Investment Company Act of 1940 are US laws that regulate the registration and activities of investment companies and are enforced by the United States Securities and Exchange Commission (“USSEC”).

Bermuda is another example of a jurisdiction that recognizes the qualified investor concept. That country’s stock exchange “...allowed the development of the Bermuda Stock Exchange (“BSX”) Mezzanine Market which offers growing E-commerce, high tech and development stage companies the opportunity to list on a recognized international stock exchange at a much earlier stage than is currently possible in any other jurisdictions. This is due in large part to the fact that the BSX restricts Mezzanine Market investment to ‘Qualified Investors.’ ”<sup>3</sup>

This discussion paper considers the rationale in mature markets for the separation of investors based on financial savvy, net worth, annual income or total assets and the need in the Jamaican capital markets to do the same. By legally defining the terms “Qualified Individual Investor” and “Qualified Institutional Investor,” the Financial Services Commission (“FSC”) could then incorporate them into its regulations. As such, the purpose of this paper is to stimulate discussion of the concept of “Qualified Investor” in the context of the Jamaican capital markets. Feedback from investors, market intermediaries and professionals, regulators, policy makers, academics and other interested parties will assist the FSC in developing regulatory policies in relation to licensing and registration of securities dealers, mutual fund requirements, issuer registration requirements and disclosure standards.

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<sup>1</sup> See Appendix 3 for other terminologies and their meanings

<sup>2</sup> <http://www.srz.com/pubtemplate.asp?id=169>

<sup>3</sup> <http://www.bsx.com/mezzmarket/>

## The Concept

The FSC recognizes that there are issuers, dealers and investment funds that want to target selected financial product offerings to a qualified investor base. They seek flexibility so that they can develop products that are more suitable for the knowledge level, risk profile and financial standing of those investors. By restricting their investor base to qualified investors, these entities would not have to meet the full registration, reporting and examination requirements of the FSC. However, the FSC would make it mandatory for them to certify and keep records of the qualified investor status based on the FSC's prescribed tests. The FSC would also rely more on full disclosure than prescriptive regulations for investor protection purposes. This approach is set out below:

- 1) Net worth, income and total asset tests used to define qualified investors status. (Appendix 1)<sup>4</sup>

The FSC recognizes that the class of "qualified investors" would have to be defined adequately to ensure that investors are capable of safeguarding their interests. As such, the FSC considers that a good starting point would be to use the appropriate segments of the definition of "accredited investor" as used by the USSEC, as follows:<sup>5</sup>

- a. A charitable organization, corporation, or partnership with assets exceeding US\$5 million;
  - b. A director, executive officer, or general partner of the company selling the securities;
  - c. A business in which all the equity owners are qualified investors;
  - d. A natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds US\$1 million at the time of the purchase;
  - e. A natural person with income exceeding US\$200,000 in each of the two most recent years or joint income with a spouse exceeding US\$300,000 for those years and a reasonable expectation of the same income level in the current year; or
  - f. A trust with assets in excess of US\$5 million, not formed to acquire the securities offered, whose purchase of the securities is directed by a person who has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.
- 2) Qualified investors required to confirm in writing their status based on the tests described in (1) above.

Utilizing the "qualified investor" categorization would free issuers from certain registration, reporting and inspection requirements. However, as mentioned above, allowing this defined investor base would place certain responsibilities on issuers and investors. Primarily, the FSC would require confirmation that the investor possesses the financial wherewithal to withstand

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<sup>4</sup> See other definitions in Appendix 3

<sup>5</sup> <http://www.sec.gov/answers/accred.htm>

losses on his or her investment. The confirmation would be done using an FSC prescribed form. An example of such a form is in draft form in Appendix 2. The issuer would be required to keep this form on record for inspection by auditors and the FSC for a prescribed period.

- 3) Differential registration, reporting and examination requirements for issuers, dealers and investment funds.

The following table sets out suggested registration, reporting and examination levels for different classes of investors.

<b>Investment Funds offered to:</b>	<b>Registration Requirements</b>	<b>Reporting Requirements</b>	<b>Examination Requirements</b>	<b>Other</b>	<b>Obligations of fund managers</b>
Qualified individual investors	Minimal	Minimal	Minimal	1) No limit on number of qualified investors that can participate in offering  2) Fund adviser to be registered	Investor certification and record keeping
1) Institutional investors managing <b>fiduciary</b> funds and are licensees	Full registration requirements if investment funds are repo'ed to non-qualified investors.	Full reporting requirements if investment funds are repo'ed to non-qualified investors.	Full examination requirements if investment funds are repo'ed to non-qualified investors.	FSC's current requirements for Fund advisers	FSC's current requirements for record keeping.
2) Institutional investors managing <b>proprietary</b> funds and are licensees	Minimal registration requirement; limit the amount of the investment; or ensure that it is captured in new capital adequacy requirements	Minimal	Minimal	Fund adviser to be registered	Asset test

## **Rationale for differential regulatory oversight for funds held exclusively by "qualified investors"**

The primary rationale for defining a segment of the investor population as "qualified investors" rests on the premise that "qualified investors" do not need the FSC's full regulatory protections. It is believed that these qualified investors are in a position to appreciate the risks associated with different types of investments and that they also possess the financial wherewithal to withstand negative changes in the value of those investments. Such persons are also able to obtain the benefit of independent professional legal, accounting, tax and investment advice in relation to their investments.

The acceptance and implementation of this concept would do the following:

1. Facilitate the development of stricter standards to protect retail or the "small" investor without impeding capital formation.
2. Facilitate the focusing of scarce regulatory resources on protecting the interests of those that most need such protection and can least afford it.
3. Enhance capital markets by freeing the wealthy to invest onshore.
4. Allow creativity of product development but with an emphasis on disclosure and an appropriate level of monitoring.

## **Public Education**

Although the qualified investor concept may prove to be appropriate for the Jamaican capital market, there would be a need for public education so that the concept is understood and the implementation and maintenance requirements are fully discussed. This paper represents the beginning of such a discussion.

## **Questions**

This paper is intended to stimulate discussion of the concept of "qualified investor". Please consider the following questions as you think about the issues in this paper:

- 1) Is the concept of qualified investor relevant for the Jamaican capital markets?
- 2) Can investors be educated to understand the legal definition?

- 3) Will the issuers, dealers and investment funds consistently confirm the investor status based on the prescribed tests: annual income, net worth, or total assets?
- 4) What is your reaction to the definition of qualified investor, as described on page 2? Can you suggest other definitions?
- 5) Will the use of the qualified investor classification spur capital formation?
- 6) Do all investors need the FSC's full regulatory protection regardless of their financial standing?
- 7) Do all issuers of financial products and investment funds need to register with the FSC or should there be exemption if the issuers' products or the investment funds are sold exclusively to qualified investors?

The FSC invites your comments. Please address them to: Senior Director - Securities, Financial Services Commission, 39-43 Barbados Avenue, Kingston, Jamaica; e-mail: [securities@fscjamaica.org](mailto:securities@fscjamaica.org)

## Appendix 1

The table below shows the net worth, annual income and total asset tests used in the US and Canada to segregate the investor base. Jamaica is shown with the same tests as that of the US. The comparison also includes the per capita income for each country and the various tests (net worth, annual income and total assets) as multiples of the respective country's per capita income.

Expressed in USD

<b>Countries</b>	<b>2003 Per capita income</b>	<b>Net Worth</b>	<b>Annual Income</b>	<b>Total Assets</b>	<b>Net Worth as multiple of per capita income</b>	<b>Annual Income as multiple of per capita income</b>	<b>Total Assets as multiple of per capita income</b>
<b>United States</b>	37,610						
Joint		1,000,000	300,000		27	8	
Individual		1,000,000	200,000		27	5	
Trust				5,000,000			133
Organization				5,000,000			133
<b>Canada</b>	23,930						
Joint			220,240	734,134	9	31	31
Individual			146,827	734,134	6	6	31
Trust				N/A			
Organization*				3,670,669			153
<b>Jamaica</b>	3,790						
Joint		1,000,000	300,000		264	79	
Individual		1,000,000	200,000		264	53	
Trust				5,000,000			1,319
Organization				5,000,000			1,319

\*Organization means company, limited partnership, limited liability partnership, trust or estate other than a mutual fund or non-redeemable investment fund

**Appendix 2**

**CONFIRMATION OF STATUS AS QUALIFIED INVESTOR<sup>8</sup>**

(ALL INFORMATION WILL BE TREATED CONFIDENTIALLY)

I represent that the information set forth below, as indicated by the boxes I have checked, is true and correct and that all other information contained in my Account Application for Individual, Joint and Custodial Accounts continues to be true and correct:

- I had individual gross income (exclusive of any income attributable to my spouse) of more than \$\_\_\_\_\_ in each of the most recent two tax years and I reasonably expect to have individual gross income in excess of \$\_\_\_\_\_ for the current tax year.
- My spouse and I together had gross income of more than \$\_\_\_\_\_ in each of the two most recent tax years and I reasonably expect that we will have gross income in excess of \$\_\_\_\_\_ for the current tax year.
- I have individual net worth (total assets less total liabilities) or my spouse and I have a combined net worth in excess of \$\_\_\_\_\_.
- My spouse and I have a combined net worth in excess of \$\_\_\_\_\_.
- I own \$\_\_\_\_\_ or more in investments in securities, real estate (excluding my residence), cash, and cash equivalents held for investment, reduced by any related indebtedness.

Please sign and date this form and send it to:

Qualified Investor/Name of Company

\_\_\_\_\_  
Name #1

\_\_\_\_\_  
Name #2

\_\_\_\_\_  
TRN

\_\_\_\_\_  
TRN

\_\_\_\_\_  
Signature #1

\_\_\_\_\_  
Signature #2

<sup>8</sup> Modified from example from WR Hambrecht + Company

### Appendix 3

There are many terms used to describe persons or institutions believed to possess the understanding of investment products and the risks and who have the financial wherewithal to withstand deterioration in the value of those investments. In the US, the Securities and Exchange Commission (“USSEC”) has defined the following:

1. **Accredited investor** is defined in rule 501(a) of Regulation D under the 1933 Act. It is the USSEC’s designation for an individual or entity meeting any of the criteria listed below.

- a) 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.
- b) Any natural person whose individual net worth, or joint net worth with that person’s spouse, at the time of his purchase exceeds US\$1,000,000.
- c) Any natural person who had individual income in excess of US\$200,000 in each of the two most recent years or joint income with that person’s spouse in excess of US\$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.
- d) Any trust with total assets in excess of US\$5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase of the securities is directed by a person who has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.
- e) Any organization that was not formed for the purpose of acquiring the securities being sold, with total assets in excess of US\$5,000,000.
- f) And, any entity in which all of the equity owners are Accredited Investors.

Certain restricted offerings, limited partnerships, and angel investor networks are open only to accredited investors. This is the **opposite of** nonaccredited investor.

#### **What is the difference between an accredited investor and a qualified investor?<sup>9</sup>**

One difference is that "accredited investor" is a legal term specifically defined by the federal securities laws while "qualified investor" is a term of art that has no legal

<sup>9</sup> [http://www.investorwords.com/57/accredited\\_investor.html](http://www.investorwords.com/57/accredited_investor.html)

definition. However, an investor who might otherwise be considered "qualified" still might not meet the definition of an accredited investor given the net worth, income or asset tests.

### **Accredited Investor Rule - Ontario<sup>10</sup>**

The Ontario Securities Commission has approved a new rule (Rule 45-501) dealing with exempt purchases. The new rule preserves the existing CA\$150,000 exemption and creates a new exemption for "accredited investors". Investors that qualify as "accredited investors" may make investments, which do not meet the current CA\$150,000 threshold for exempt purchases. This Rule came into force on November 30, 2001.

#### **An "Accredited Investor" includes:**

- a) Individuals who beneficially own or together with a spouse own financial assets of CA\$1,000,000 (before taxes but net of any liabilities).
- b) Individuals whose net income before taxes exceeded CA\$200,000 in each of the last two years or whose net income before taxes combined with that of their spouse exceeded CA\$300,000 in each of those years and who has a reasonable expectation of exceeding the same income in the current year.
- c) A company, limited partnership, limited liability partnership, trust or estate (other than a mutual fund or non-redeemable investment fund) that has net assets of at least CA\$5,000,000 as reflected in its most recent financial statements.

Investors in Ontario who qualify as "accredited investors" are permitted to invest a minimum as low as CA\$5,000 in some Hedge Funds rather than having to invest a minimum of CA\$150,000.

Investors who do not qualify as "accredited investors" are still permitted to invest in Hedge Funds provided that they invest a minimum of CA\$150,000. Investors who have already invested a minimum of CA\$150,000 and who do not qualify as "accredited investors" are permitted to make additional purchases provided that they still hold their original investment (i.e. they have not redeemed units which bring them below the CA\$150,000 threshold).

2. **Qualified Institutional buyers** are defined in rule 144a(a)(1) of the Securities and Exchange Commission under the 1933 act.

Rule 144a is a USSEC rule that modified a two-year holding period requirement on privately placed securities by permitting Qualified Institutional Buyers (QIBs) to trade

<sup>10</sup> [http://www.canadianhedgewatch.com/AIR\\_Ontario.asp](http://www.canadianhedgewatch.com/AIR_Ontario.asp)

these positions among themselves.<sup>11</sup> It is an exemption for sale of restricted stock between qualified institutions.

Rule 144A -- Private Resales of Securities to Institutions<sup>12</sup>.

*7.a Definitions.*

For purposes of this section, *qualified institutional buyer* shall mean:

Any of the following entities, acting for its own account or the accounts of other qualified institutional buyers, that in the aggregate owns and invests on a discretionary basis at least US\$100 million in securities of issuers that are not affiliated with the entity:

A. Any *insurance company* as defined in section 2(a)(13) of the Act ;

Note: A purchase by an insurance company for one or more of its separate accounts, as defined by section 2(a)(37) of the Investment Company Act of 1940 (the "Investment Company Act"), which are neither registered under section 8 of the Investment Company Act nor required to be so registered, shall be deemed to be a purchase for the account of such insurance company.

B. Any *investment company* registered under the Investment Company Act or any *business development company* as defined in section 2(a)(48) of that Act;

C. Any *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;

D. Any *plan* established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees;

E. Any *employee benefit plan* within the meaning of title I of the Employee Retirement Income Security Act of 1974;

F. Any trust fund whose trustee is a bank or trust company and whose participants are exclusively plans of the types identified in paragraph (a)(1)(i)(D) or (E) of this section, except trust funds that include as participants individual retirement accounts or H.R. 10 plans.

<sup>11</sup> <http://www.investopedia.com/terms/r/rule144a.asp>

<sup>12</sup> <http://www.law.uc.edu/CCL/33ActRIs/rule144A.html>

- G. Any *business development company* as defined in section 202(a)(22) of the Investment Advisers Act of 1940;
- H. Any organization described in section 501(c) (3) of the Internal Revenue Code, corporation (other than a bank as defined in section 3(a)(2) of the Act or a savings and loan association or other institution referenced in section 3(a)(5)(A) of the Act or a foreign bank or savings and loan association or equivalent institution), partnership, or Massachusetts or similar business trust; and
- I. Any *investment adviser* registered under the Investment Advisers Act.

3. **Qualified purchasers** are defined in Section 2(a)(51) of the 1940 Act

Section 2 – Definitions: 51(a) of the Investment Company Act of 1940

- A. **"Qualified purchaser"** means--
  - i. any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) [15 USCS § 80a-3(c)(7)] with that person's qualified purchaser spouse) who owns not less than US\$ 5,000,000 in investments, as defined by the Commission;
  - ii. any company that owns not less than US\$ 5,000,000 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 US\$ 25,000,000 in investments.
- B. The Commission may adopt such rules and regulations applicable to the persons and trusts specified in clauses (i) through (iv) of subparagraph (A)

as it determines are necessary or appropriate in the public interest or for the protection of investors.

- C. The term "qualified purchaser" does not include a company that, but for the exceptions provided for in paragraph (1) or (7) of section 3(c) [15 USCS § 80a-3(c)(1) or (7)], would be an investment company (hereafter in this paragraph referred to as an "excepted investment company"), unless all beneficial owners of its outstanding securities (other than short-term paper), determined in accordance with section 3(c)(1)(A) [15 USCS § 80a-3(c)(1)(A)], that acquired such securities on or before April 30, 1996 (hereafter in this paragraph referred to as "pre-amendment beneficial owners"), and all pre-amendment beneficial owners of the outstanding securities (other than short-term paper) of any excepted investment company that, directly or indirectly, owns any outstanding securities of such excepted investment company, have consented to its treatment as a qualified purchaser. Unanimous consent of all trustees, directors, or general partners of a company or trust referred to in clause (ii) or (iii) of subparagraph (A) shall constitute consent for purposes of this subparagraph.

In 2002, The Securities and Exchange Commission proposed a definition for the term "qualified purchaser" under the Securities Act of 1933 to implement a provision of the National Securities Markets Improvement Act of 1996. The definition is now incorporated in Section 2(a)(51) of the 1940 Act and mirrors the definition of accredited investor under Regulation D of the Securities Act. The new qualified purchaser definition identifies well-established categories of persons who are financially qualified and therefore not in need of the protection of state registration when they are offered or sold securities. At the time of this proposal, the USSEC believed that the category of "qualified purchaser" should facilitate capital formation, especially for small businesses. In addition, the USSEC said that getting this terminology incorporated in the law would implement the Congressional intent, impose uniformity in the regulation of transactions to these financially qualified persons and reduce burdens on capital formation.<sup>13</sup>

4. **Qualified investor**<sup>14</sup> is defined in Section 3(a)(54) of the Securities Exchange Act of 1934 (as amended by Section 207 of the Gramm-Leach-Bliley Act of 1999)

A. **Definition**

Except as provided in subparagraph (B), for purposes of this title, the term 'qualified investor' means--

<sup>13</sup> <http://www.sec.gov/rules/proposed/33-8041.htm>

<sup>14</sup> <http://www.law.uc.edu/CCL/34Act/sec3.html>

- i. any investment company registered with the Commission under section 8 of the Investment Company Act of 1940;
- ii. any issuer eligible for an exclusion from the definition of investment company pursuant to section 3(c)(7) of the Investment Company Act of 1940;
- iii. any bank (as defined in paragraph (6) of this subsection), savings association (as defined in section 1813(b) of Title 12), broker, dealer, insurance company (as defined in section 2(a)(13)) of the Securities Act of 1933, or business development company (as defined in section 2(a)(48) of the Investment Company Act of 1940);
- iv. any small business investment company licensed by the United States Small Business Administration under section 681(c) or (d) of this title;
- v. any State sponsored employee benefit plan, or any other employee benefit plan, within the meaning of the Employee Retirement Income Security Act of 1974, other than an individual retirement account, if the investment decisions are made by a plan fiduciary, as defined in section 1002(21) of Title 29, which is either a bank, savings and loan association, insurance company, or registered investment adviser;
- vi. any trust whose purchases of securities are directed by a person described in clauses (i) through (v) of this subparagraph;
- vii. any market intermediary exempt under section 3(c)(2) of the Investment Company Act of 1940;
- viii. any associated person of a broker or dealer other than a natural person;
- ix. any foreign bank (as defined in section 3101(b)(7) of Title 12);
- x. the government of any foreign country;
- xi. any corporation, company, or partnership that owns and invests on a discretionary basis, not less than US\$25,000,000 in investments;
- xii. any natural person who owns and invests on a discretionary basis, not less than US\$25,000,000 in investments;

- xiii any government or political subdivision, agency, or instrumentality of a government who owns and invests on a discretionary basis not less than US\$50,000,000 in investments; or
- xiv any multinational or supranational entity or any agency or instrumentality thereof.

**5. High Net Worth Individual**

This is an individual with at least US\$750,000 managed by an investment manager, or whose net worth the investment manager reasonably believes exceeds US\$1,500,000, or who is a “qualified purchaser” as defined in section 2(a)(51)(A) of the Investment Company Act of 1940. The net worth of an individual may include assets held jointly with his or her spouse.

**6. Qualifying Fund Investor**<sup>15</sup>

All of the Irish Financial Services Regulatory Authority’s investment and borrowing restrictions are automatically derogated from for a QIF. To qualify as a QIF, the minimum subscription is EUR 250,000. In addition, the investor must be either:

- (i) a person with minimum net worth of EUR 1,250,000 excluding main residence and household goods or
- (ii) an institution (a) which owns or invests on a discretionary basis at least EUR 25 million or its equivalent in other currencies or (b) the beneficial owners of which are qualifying investors in their own right.

The qualifying investor is required to certify itself as such on the application form for investment in the fund. The Irish Financial Services Regulatory Authority Notice NU24 deals with QIF funds.

The above persons or institutions are granted exemptions or allowed to participate in restricted transactions as they are generally regarded as having a high degree of financial knowledge and wherewithal that he or she or the institution does not need the protections afforded by registration with the regulatory authorities. In Ontario, the Accredited Investor Exemption permits issuers to raise any amount at any time from any person or company that meets the specified qualification criteria.

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<sup>15</sup> <http://www.dfia.ie/index.php>