

# The New York Law Journal

## The Employees' Securities Company: An Employee Retention Vehicle

EXPERT OPINION  
November 24, 2023

By David A. Form, Oren Gertner and Ellie S. Cohen

Over the past 40 years, investment banks, financial institutions and professional services firms have used employees' securities companies (ESCs) as a means of allowing senior employees of the employer (the "applicant") to participate in certain investment opportunities.



David A. Form, Ellie S. Cohen and Oren Gertner

Investment vehicles established pursuant to an ESC order facilitate investments by the applicant or its affiliates and certain of the applicant's employees (individually and indirectly through certain controlled entities) and such employees' immediate family members.

ESC funds allow these individuals to invest in various types of investment opportunities, including hedge funds, private equity funds and venture capital funds and/or underlying investments for which these investors individually may not have the opportunity to

invest and facilitate diverse investment opportunities for such investors.

In recent years, a number of professional service firms (including law firms and consulting firms) have established ESCs. For many of these applicants, establishing an ESC is an opportunity to provide their employees with benefits intended to compete with those offered by certain other industries, such as investment banking and financial services.

In addition, a number of applicants have recently established ESCs or offered participation in an ESC to additional employees in order to utilize their ESC as tools for employee retention or as an internal service relating to the management of employees' wealth. In light of an employee-favorable job market, benefits offered by certain private companies, particularly tech companies, and the interest in emerging fields and technologies, many applicants view ESCs as a powerful retention tool. For example, some ESC funds offer investors the chance to invest in venture capital funds or portfolio companies, allowing employees financial exposure to "in demand" tech companies, climate related investments, emerging industries and other potentially high-return investments.

Further, certain applicants structure employee bonus and compensation

packages to invest alongside employees in the ESC fund, further amplifying the power of ESCs as a retention tool. This article describes in summary the process of establishing an ESC, the eligibility criteria for an ESC and the types of investments in which ESCs may participate. It also discusses recent trends in the ESC process.

### **What is an ESC?**

An ESC is a type of investment entity operating pursuant to certain exemptive relief granted by the Investment Company Act of 1940 (the “1940 Act”). The 1940 Act defines an ESC as “any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned (A) by the employees or persons on retainer of a single employer or of two or more employers each of which is an affiliated company of the other, (B) by former employees of such employer or employers, (C) by members of the immediate family of such employees, persons on retainer, or former employees, (D) by any two or more of the foregoing classes of persons, or (E) by such employer or employers together with any one or more of the foregoing classes of persons.”

An ESC receives improved regulatory treatment due to the close nexus of the applicant with its employees. The primary benefit of this close relationship is that the applicant, through the ESC application, seeks waivers of many requirements of the 1940 Act, including many of the reporting requirements. These waivers are received under orders granted by the Securities and Exchange Commission (SEC) pursuant to Section 6(b) of the 1940 Act. Without the ESC exemption, the 1940 Act would generally limit an investment vehicle established by the applicant either to 100 investors or only qualified purchasers.

If an ESC fund has more than \$25 million in net assets or commitments, the ESC fund itself will be treated as a qualified purchaser for purposes of investing in other funds. This enables an ESC fund to invest in a diverse group of hedge funds, private equity funds, venture capital funds and other products.

It should be noted, however, that because of certain regulatory requirements and rules, ESCs cannot invest in securities issued by registered investment companies if, immediately after such acquisition, the ESC would own more than 3% of the outstanding voting stock of the registered investment company.

In addition, ESC orders do not provide any exemption on the rules governing an ESC’s eligibility to invest in a fund relying on Section 3(c)(1) or Section 3(c)(7) of the 1940 Act, but a previous no-action letter suggested an ESC would only be counted as one beneficial owner, without a look-through to the ESC’s underlying investors, even if the ESC invests exclusively in a fund relying on Section 3(c)(1) or, potentially, Section 3(c)(7), so long as the ESC owns less than 10% of the outstanding shares of such underlying fund.

### **Factors Considered for Exemption**

Section 6(b) of the 1940 Act requires that in granting an exemption from the 1940 Act, the SEC give due weight to, among other things, the form of organization and capital structure of the ESCs; the persons who will own and control the company’s voting securities; the prices at which securities issued by the company will be sold and any applicable sales charge; the disposition of the proceeds issued by the company; the nature of the securities in which those proceeds will be invested; and the existence of any relationship between the company and the issuers of securities held by such company.

Recently, in reviewing applications, the SEC has placed emphasis on utilizing the language of previously-approved applications. Specifically, the SEC values the use of precedential application language from a previously-approved ESC relating to a similar applicant.

For example, if an applicant is a registered investment advisor, then the applicant should consider utilizing the language of a recently-approved registered investment advisor applicant.

Furthermore, while the SEC has indicated it would consider any previously-approved application as precedent, it has recently encouraged applicants to reference the newest, most recently-approved applications.

While the SEC seems to be prioritizing the use of recent and similarly situated applicant precedent applications, the SEC is also concerned about potential conflicts of interest, conflict mitigation and protection against improper use of material non-public information.

The SEC has indicated particular concern about compliance policies and procedures for applicants that are not registered investment advisors. Because these applicants are not subject to certain registered investment advisor rules, regulations and guidelines, the SEC seems focused on ensuring such applicants have sufficient policies and procedures in place to address conflicts of interest and other compliance issues.

### **Who May Participate?**

Participation in an ESC is generally limited to the applicant, the applicant's employees (as described below) and the immediate family members of such employees, in each case,

who meet certain thresholds.

Notwithstanding the regulatory requirements and guidelines on eligibility, applicants often invite only certain eligible groups of senior personnel to invest in an ESC.

Most ESC funds limit participation to "accredited investors" (as defined in Rule 501(a)(5) or (6) of Regulation D under the Securities Act of 1933), while some ESC funds allow up to 35 non-accredited investors who meet certain sophistication qualifications. In such situations, such non-accredited investors generally must meet certain educational, workforce and financial requirements.

A frequent formulation requires non-accredited investors to have (a) a graduate degree in business, law or accounting, (b) a minimum of five years of consulting, investment management, investment banking, legal or similar business experience, and (c) reportable income from all sources (including any profit shares or bonus) of \$100,000 in each of the two most recent years immediately preceding the employee's admission as an investor of the ESC fund and have a reasonable expectation of income from all sources of at least \$140,000 in each year in which the employee will be committed to make investments in the ESC fund. If non-accredited investors are admitted to an ESC fund, such investors are generally limited to investing no more than 10% of their income in such ESC fund.

Certain family members, generally spouses, parents, children, spouses of children, brothers, sisters and, more recently, grandchildren (including step and adoptive relationships), may also invest in an ESC. While family members may invest in an ESC, any such family member cannot be more than two generations removed from the eligible employee. This is intended to ensure

a nexus always exists between the applicant and the ESC investor.

Employees that would otherwise be eligible to invest in an ESC fund may do so through certain controlled entities, namely a trust of which a trustee, grantor and/or beneficiary is an eligible employee; a partnership, corporation or other entity controlled by an eligible employee; and a trust or other entity established solely for the benefit of eligible employees and/or eligible family members. Any such entity must be an accredited investor.

While the 1940 Act itself does not strictly limit the number of employees that may participate in an ESC, Section 12(g) of the Securities Exchange Act of 1934 Act requires registration if there are at least 2,000 investors, unless other exceptions apply. As ESCs are generally established to minimize regulatory burden, most ESCs operate with the goal of remaining below the registration threshold.

### **What Investments Can an ESC Make?**

ESC funds may make a range of investments, provided the general objective is disclosed in the application. ESCs commonly aggregate funds of the investors to enable employees to make investments to which they may not normally have access. This includes investments in other investment funds, investments alongside angel or venture capital investors and investments directly in targets or portfolio companies of other investment funds. If an ESC were to pursue a strategy not previously disclosed in a different, approved application, the SEC may have additional questions about the applicant's intended strategy.

Approved ESC applications permit ESC funds to invest in (or alongside) multiple strategies offered by the applicant or third-parties.

Potential investments for ESCs may include a wide variety of U.S. and non-U.S. assets, investments in operating companies, registered or unregistered funds, including but not limited to public and private debt and equity securities, real estate, credit and other financial assets.

### **When the Employee Leaves**

While former employees are eligible to invest in ESC funds pursuant to recent applications, the question of what happens when an employee leaves is a pressing concern for applicants. Applications generally refer to an ESC's underlying fund documents as to the process when someone is no longer affiliated with the applicant, whether the departure is a result of death or a job change. However, as discussed above, a family member more than two generations removed from the eligible employee may not continue to invest in an ESC fund.

In an ESC fund's underlying fund documents, the fund and its manager are typically granted broad authority to mandatorily withdraw investors. Mandatory withdrawal is more likely to occur in a situation where the investor has left the applicant on poor terms, but certain ESC funds redeem all former employees as a matter of course. When such situations arise, this is an area where it is helpful for the applicant to discuss potential options with their legal counsel. Since the ESC guidelines are somewhat broad on this topic, ESCs often structure themselves with similarly broad authority and discretion.

Certain applicants take the view that, in order to maintain the exclusivity of their employee investment program and to keep their investment strategies confidential, former employees are not offered the opportunity to invest in ESC funds launched after an employee's termination date. Other

applicants, however, emphasize that alumni are part of the organization for purposes of allowing them to participate in all of the applicant's ESC funds, which can attract current employees to participate in the ESC funds, knowing that those opportunities will continue to be available even after they cease to be employed by the applicant.

### **Looking to the Future**

A recent area of focus for the SEC when considering ESC applications is the risk of insider trading and conflicts of interest generally. This focus seems of particular importance for applicants other than registered investment advisors, such as law firms and consulting firms. Enforcement actions in recent years have shed further light on the importance of adequate policies and procedures to address insider trading, particularly in the ESC context. In addition, the SEC appears focused on the use of recent and relevant precedential language.

While applicants granted orders of exemptive relief are exempt from certain reporting and compliance obligations, applicants and ESCs remain subject to some compliance obligations.

Changes to SEC rules, regulations, guidelines and policies, including shifting examination

priorities and proposed rule changes to Regulation S-P regarding reporting on incidents of cybersecurity breaches and the Corporate Transparency Act, could impose additional obligations on applicants. In addition, the SEC's focus on conflicts (including conflicts that may arise in connection with the applicant's regular course of business) and insider trading risk mitigation could impact the compliance obligations of applicants.

For example, certain applicants develop detailed policies regarding conflicts arising in connection with investment decisions relating to investments in the applicant's clients or when there are other relations that link the investment opportunity with the applicant.

Applicants may also consider developing policies regarding secondaries opportunities in the ESC funds and the extent to which, and under what circumstances, the applicant would take an active role. Finally, applicants with an international presence should consider whether to offer non-US employees the opportunity to participate in the ESC funds and consider and confirm the securities and tax complications associated with such offerings.

[David Form](#) is a partner at Sidley in the firm's investment funds group. [Oren Gertner](#) is also a partner in Sidley's investment funds group and is a member of the firm's private equity fund formation practice. [Ellie Cohen](#) is an associate in the firm's investment funds group.

Reprinted with permission from the November 24, 2023 edition of the *New York Law Journal* © 2023 ALM Global Properties, LLC. All rights reserved. Further duplication without permission is prohibited, contact 877-256-2472 or [asset-and-logo-licensing@alm.com](mailto:asset-and-logo-licensing@alm.com).