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SECURITIES LAW CONSIDERATIONS FOR PRIVATE FUND FORMATION

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This article is for private fund sponsors and managers who want to start a new fund or restructure their existing funds.

Please click here for *ABCs of Hedge Fund Formation - Structural Options*

I. Fund Regulation: Avoid Triggering Investment Company Status

The Investment Company Act of 1940 (the "ICA") defines an "investment company" as any issuer of securities that is engaged primarily in the business of investing, reinvesting or trading securities, and it prohibits any investment company from engaging in the business of buying and selling securities unless it has registered with the SEC or has a valid exemption from registration. Hedge funds and similar pooled investment vehicles fall within the definition of an "investment company" and therefore are required to register as an investment company unless they qualify for an exemption.

Offshore funds seeking to market their securities (fund products) to U.S. investors or in the United States must also be sensitive to the ICA. The ICA prohibits offshore funds from making a public offering in the U.S. through U.S. jurisdictional means (i.e., the U.S. mail or any means or instrumentality of interstate commerce) unless the SEC issues an order permitting it to register under the ICA. As a practical matter, the standard imposed by the ICA requires offshore funds to organize and operate themselves as registered investment companies, which has prevented most offshore funds from obtaining the necessary SEC order.

Most hedge funds, venture capital funds, private equity funds and similar pooled investment vehicles rely on two provisions of the ICA for registration exemption: Section 3(c)(1) and Section 3(c)(7).

Section 3(c)(1) of the ICA, in part, provides an exemption from its registration requirement for a fund whose securities are beneficially owned by not more than 100 "persons" at any given time; or, in case of a qualifying venture capital fund with less than $10 million in aggregate capital contributions and uncalled capital commitments, not more than 250 persons. Private fund managers most commonly rely upon Section 3(c)(1) to obtain registration exemption.

Section 3(c)(7) of the ICA, in part, exempts funds from its registration requirement without limitation as to the number of its beneficial owners as long as the securities are owned exclusively by "qualified purchasers." A fund with 2,000 or more investors, however, is required to register its securities with the SEC.

A fund operating pursuant to an exemption under either Sections 3(c)(1) or 3(c)(7) of the ICA may not make any public offering of its securities under the Securities Act of 1933. There are also restrictions on advertising and general solicitation by funds relying on either the Section 3(c)(1) or Section 3(c)(7) exemption.

1. The 100-Beneficial Owner Requirement

For purposes of counting investors in connection with the 100-person limitation imposed by Section 3(c)(1) of the ICA, normally each person is counted separately and joint ownership by spouses is considered held by one beneficial owner. "Person" is defined to mean a "natural person or a company." The SEC will "look through" a company that invests in a fund and count each of the security holders of that company as a separate investor of the fund if: (i) the company investing in the fund is either a registered investment company or a private investment company organized pursuant to an exemption under either Section 3(c)(1) or Section 3(c)(7) of the ICA; and (ii) the company beneficially owns 10% or more of the outstanding voting securities of the fund. For offshore funds relying on Section 3(c)(1) that accept U.S. tax-exempt investors, only U.S. investors are counted towards the 100-person limitation.

The Integration Doctrine

When a fund begins to approach the limit on the number of investors (e.g. 100 persons or 250 persons in the case of a qualified venture fund), the manager cannot avoid the limitation by forming another fund identical to the prior fund.

To prevent managers from creating identical funds each time they approach the 100-person limitation, the SEC applies the "integration" doctrine. In the event that two or more funds that are managed by the same sponsor are substantially similar, the SEC will "integrate" such funds so that they will be deemed to constitute one issuer. If the SEC integrates two or more funds, it combines the number of each fund's investors to determine whether the funds, in the aggregate, are owned by more than 100 persons.

The SEC will not integrate two funds if one is a Section 3(c)(1) fund and the other fund is a Section 3(c)(7) fund. Additionally, the SEC normally does not integrate domestic funds and offshore funds.

2. Qualification Of Investors In A Section 3(c)(1) Fund

For a fund relying on the Section 3(c)(1) exemption, ownership interests in the fund are typically offered to investors pursuant to Rule 506 of Regulation D of the Securities Act of 1933. Securities offered under Rule 506 of Regulation D may be sold solely to “accredited investors” and, under certain circumstances, up to 35 “sophisticated investors.”

Regulation D provides eight categories of “accredited investor,” which include but are not limited to:

- An individual whose net worth, or joint net worth with his or her spouse, at the time of purchase exceeds $1,000,000 (excluding the net value of the investors’ personal residence under the Dodd-Frank Act);

- An individual whose individual annual gross income exceeded $200,000, or whose combined annual gross income with his/her spouse exceeded $300,000, in each of the two most recent years, and who has a reasonable expectation of an income in excess of $200,000 individually, or in excess of $300,000 with his or her spouse, in the current year;

- Any executive officer, director, managing member or general partner of the issuer of the securities offered;

- An employee benefit plan within the meaning of Title I of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), (a) whose investment decisions are made by a plan fiduciary, as defined in Section 3(21) of ERISA, which is either a bank, insurance company or registered investment adviser; or (b) having total assets in excess of $5,000,000; or (c) if self-directed, the investment decisions are made solely by persons that are accredited investors;

- A trust (and other vehicles), with total assets in excess of $5,000,000, that was not formed for the specific purpose of acquiring an interest in the fund and whose purchase is directed by a sophisticated investor; and

- An entity in which each of the equity owners are accredited investors.

A “sophisticated investor” means an investor, either alone or with the investor’s purchaser representative(s), who has such knowledge and experience in financial and business matters that the investor is capable of evaluating the merits and risks of an investment in the fund.

3. Qualification Of Investors In A Section 3(c)(7) Fund

A person may not invest in a Section 3(c)(7) fund unless such person meets the definition of a "qualified purchaser." The term "qualified purchaser" includes:

- Any natural person who owns not less than $5 million in investments;

- Any "family owned company" that owns at least $5 million in investments and is directly or indirectly owned by or for two or more natural persons who are related as siblings or spouses (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estate of such persons or foundations/charitable organizations/trusts established by or for the benefit of such persons;

- Any other trust that was not formed for specific purpose of acquiring the securities of the Section 3(c)(7) fund and as to which the trustee and each settlor or other person contributing assets to the trust are qualified purchasers; and

- Any other person (e.g., an institutional investor) acting for his/her/its own account or the accounts of other qualified purchasers, who in aggregate owns and invests on a discretionary basis not less than $25 million in investments.

II. Fund Manager Regulation: Investment Advisers Act

The Investment Advisers Act of 1940 (the "Advisers Act") defines an "investment adviser" generally to include a natural person or entity who, for compensation, engages in the business of providing advice to others regarding securities. Investors' ownership interests in an LLC or a limited partnership are considered as securities under U.S. securities laws. The meaning of "compensation" under this definition may include any form of direct or indirect economic benefit. All private fund managers, therefore, fall within the definition of an "investment adviser." However, they may not be required to register as an investment adviser with the SEC pursuant to various exclusions and exemptions (they may still be required to register with state securities authorities). The SEC and each state impose different registration requirements and exemptions from registration for investment advisers.

A manager of a pooled investment vehicle is exempt from registering as an investment adviser under the Advisers Act, if such manager (under the Dodd-Frank Act) falls within one of the following categories:

- Intrastate Advisers: A manager is exempt from registration under the Advisers Act if its clients are all residents of the state where the manager maintains its principal office and place of business, and the manager does not give advice on securities traded on a national securities exchange.

- A private fund manager with its principal office and business in the U.S., who has clients from different states, that:
  - Has less than $150 million in assets under management within the U.S. (In calculating the value of the assets managed within the U.S., the manager must determine the fair market value of such assets on a gross basis.); and
  - Manages only private funds (funds exempt under Sections 3(c)(1) or 3(c)(7) of the ICA).

- A private fund manager with its principal office and place of business located outside the U.S.:
  - Whose US clients are all private funds; and
  - Who has less than $150 million of U.S. investors' assets under management from the U.S. location.

  A foreign manager can manage any amount of assets of a private fund in which US investors invest from a non-US location.

- A venture capital advisor that:
  - Holds itself out to investors as engaging in a venture capital strategy;
  - Does not give investors redemption rights;
  - Has no more than 20% of its assets in non-qualifying investments;
  - Limits borrowing to 15% of the fund's assets and only for a short-term period; and
  - Is not a registered investment company or a business development company.

- Small business investment company advisers:
  - An investment adviser that acts as an adviser solely to a small business investment company (SBIC) under the Small Business Investment Act of 1958 is exempt from the registration requirements of the Advisers Act.

- A foreign private advisor that:
  - Has no place of office and business in the U.S.
  - Has fewer than 15 clients and investors in the U.S. in private funds (looking through the funds to their underlying investors) advised by the manager;
  - Has less than $25 million under management attributable to U.S. clients and investors; and
  - Does not hold itself out generally in the U.S. as an investment adviser.

An exempt investment adviser may still be required to comply with the Advisers Act's other rules, including certain disclosure rules, record-keeping and reporting requirements, marketing rules, custody rules, and rules on capital raising.

Limitation on Registered Advisers Charging Performance-Based Fees

Generally, a fund manager receives performance-based compensation in addition to management fees. However, Section 205(a)(1) of the Advisers Act prohibits investment advisers who are registered or required to be registered with the SEC from receiving performance-based compensation, unless (a) the advisory contract is entered into with funds that are exempted from the definition of "investment company" in the ICA by section 3(c)(7), (b) the advisory contract is entered into with persons who are not residents of the United States, or (c) each of the investors is a "Qualified Client." A Qualified Client must be either:

- An investor that the manager reasonably believes, immediately prior to entering into the performance-based management contract, has a net worth of more than $2,000,000 or is a "qualified purchaser" as defined in the ICA at the time they enter into the contract;

- An investor that, immediately after entering into the performance-based management contract, has at least $1,000,000 under management with the manager; or

- An investor who falls within certain categories of the management or employees of the manager.

In the case of section 3(c)(1) funds, the individual investors of the fund, rather than the fund itself, are considered for purposes of determining "Qualified Client." In the case of section 3(c)(7) funds, as long as the fund itself meets the Qualified Client requirements, the manager can charge performance-based compensation.

Most states also have similar rules. The legislative intent of this rule is to prevent managers from taking undue risk with investors' assets in order to receive performance-based compensation. Some states provide relief from this prohibition on performance-based compensation by following the exceptions provided under the federal regulatory regime. Other states provide an exception that tracks an older version of the federal rule and impose contract and disclosure obligations on investment advisers.

III. Commodity Exchange Act

A fund manager must register as a commodity pool operator (CPO) under the Commodity Exchange Act if the fund trades any commodity futures contracts or options thereon. As a CPO, the manager is subject to various record-keeping, reporting and disclosure requirements under the Commodity Exchange Act and related rules adopted by the Commodity Futures Trading Commission.

In addition to the registration requirement, the fund's offering document must be approved by the National Futures Association prior to its use.

If, among other things, the fund's aggregate initial margin and option premiums for commodity transactions do not exceed 10% of the fund's assets, or if investors in the fund are limited to "qualified eligible participants," the fund may request an exemption from many of the regulatory requirements otherwise applicable to it.

In general, a "qualified eligible participant" includes any person who, in the fund manager's reasonable belief at the time that person invests in the fund, meets the following qualifications:

- Owns securities (including pool participations) of issuers not affiliated with such participant and other investments with an aggregate market value of at least $2,000,000; or

- Has had on deposit with a futures commission merchant, for its own account at any time during the six-month period preceding the date of sale to that person of an interest in the fund, at least $200,000 in exchange-specified initial margin and option premiums for commodity interest transactions.

IV. Employee Retirement Income Security Act of 1974 ("ERISA")

Employee retirement or other benefit plans, individual retirement accounts and Keogh accounts are normally considered as "benefit plan investors" when these plans/accounts invest their assets into a fund managed by a fund manager. If the aggregate investment amount from these "benefit plan investors" equals or exceeds, at any time, 25% of the aggregate equity of a fund managed by a fund manager, the fund manager will be deemed to be managing "plan assets" and thus will become a "plan fiduciary" under ERISA. As a plan fiduciary, the fund manager would be prohibited from participating in or entering into any transaction that may result in a conflict of interest with the benefit plan investors, among other restrictions.

For this reason, in order to avoid the possibility of becoming a "plan fiduciary," each time there is an investment or withdrawal in a fund, the fund manager is required to calculate the percentage of assets invested by benefit plan investors in the aggregate. The reporting on this issue is commonly handled by the fund's administrator.

This article is intended to give basic guidelines to emerging managers. The rules and regulations mentioned in this article are subject to further interpretations and exceptions. To discuss these issues further, please contact Ruth Jin and Haley Clancy.

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