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Compliance Review
Ongoing Compliance Updates for Independent Investment Advisors

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Private Fund Primer

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I. Introduction

Private funds are pooled investment vehicles formed in the United States ("domestic funds") or in foreign tax haven jurisdictions ("offshore funds") offered on a private basis to certain qualified clients. Domestic funds are generally organized as limited partnerships or limited liability companies, while offshore funds are generally organized as companies or limited partnerships.

> Regulatory requirements for private funds are substantially less burdensome than for public or mutual funds—and they are consequently less expensive to run.

Private funds give investment advisors the opportunity to manage client assets through a pooled vehicle, permitting the manager to accept and manage, if desired, smaller amounts than would be feasible in a separate account in a more cost-effective manner. New strategies can also be incubated in private funds for clients who want limited exposure to those strategies. Private funds also offer the investment advisor the ability to create accounts with terms that allow the advisor greater stability in its asset base by limiting the timing of withdrawals by investors, thereby granting the advisor greater freedom to explore investment strategies that may have longer-term horizons.

This article will explore the various legal and regulatory considerations arising from setting up and operating a private fund, including different basic fund structures and compliance challenges.

II. Legal Issues Affecting Private Funds

Although private funds are often referred to in the press as "unregulated" or "lightly regulated," they must be offered and operated in accordance with fairly stringent guidelines so that they don't run afoul of the numerous laws that govern their existence.

Federal Securities Laws

A. Securities Act of 1933

General provisions. A private fund may not engage in a public offering of its interests in the U.S. without registration under the Securities Act of 1933, as amended (the "Securities Act"). Thus, the offering of private fund interests should be structured to qualify as a private placement exempt from registration under Section 4(2) of the Securities Act.

Court decisions have not precisely defined what constitutes a public offering under the Securities Act. Apart from the "safe harbor" afforded by Rule 506 under the Securities Act (discussed below), the courts and the Securities and Exchange Commission (the "SEC") have each indicated that there is generally no public offering if an offer is made to not more than 25 to 30 persons, each of whom has sufficient business and investment sophistication, including an understanding of the risks of an investment in the private fund and the ability to bear them. It is important to note that in determining whether a public offering exists, it is the total number of offerees and not the number of ultimate purchasers that is taken into account.

Regulation D, Rule 506. Rule 506 set forth in Regulation D under the Securities Act provides certain objective standards for determining when offers or sales of securities do not constitute a "public offering" for purposes of providing a "safe harbor" exemption under Section 4(2) of the Securities Act. Rule 506 sets forth standards that relate primarily to the manner of offering (including information to be supplied to purchasers) and the nature of purchasers.

Manner of offering. Neither the private fund nor any person acting on its behalf may offer to sell or sell interests in the private fund through any general solicitation or general advertising (such as a newspaper article or advertisement, a seminar, or any circular that is distributed to the public).

> Brokers should not send private fund offering material to any investor with whom they do not already have a substantial business relationship.

Similarly, the manager should not send offering materials to investors with whom the manager or its officers or shareholders are not personally or professionally acquainted. An offering memorandum should be prepared and used in connection with the solicitation of investors.[1]

Nature of purchasers: Accredited and nonaccredited investors; net worth requirements. Rule 506 limits the number of sales of private fund interests that may be made to nonaccredited sophisticated investors to a total of 35.[2] There is no limit under Rule 506 on the number of sales that may be made to Accredited Investors (although, as discussed below, other federal securities law provisions provide other limitations on the total number of beneficial owners of private fund interests in a private fund). Under Rule 506, investors must meet certain net worth, total asset, or income requirements in order to be considered Accredited Investors. These net worth, total asset, or income requirements with respect to particular investors are summarized below:

- **Individuals.** An individual must have either a net worth (or joint net worth with his or her spouse) in excess of $1,000,000 (excluding the value of his or her primary residence)[3] or income in excess of $200,000 (or $300,000 joint income with his or her spouse) in each of the two most recent years and a reasonable expectation of attaining that income level in the current year.
- **Revocable trusts or self-directed pension plans.** The net worth of the grantor of a revocable trust or person who directs the investment of a self-directed pension plan must have either a net worth (or joint net worth with his or her spouse) in excess of $1,000,000 (excluding the value of his or her primary residence) or income in excess of $200,000 (or $300,000 joint income with his or her spouse) in each of the two most recent

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years and a reasonable expectation of attaining that income level in the current year.

- **Business corporations and business partnerships.** Business corporations, partnerships, limited liability companies, business trusts, or not-for-profit organizations, not formed for the specific purpose of acquiring the interests of the private fund offered, must have total assets in excess of $5,000,000.
- **Banks and financial institutions.** Any bank as defined in Section 3(a)(2) of the Securities Act or any savings and loan association or other institution as defined in Section 3(a)(5)(A) of the Securities Act, whether acting in its individual or fiduciary capacity; any broker or dealer registered under the Securities Exchange Act of 1934; any insurance company as defined in Section 2(13) of the Securities Act; any investment company registered under the Investment Company Act of 1940 or a business development company as defined in Section 2(a)(48) of the Investment Company Act of 1940; any small-business investment company licensed by the U.S. Small Business Administration.
- **Government plans.** Any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality thereof, for the benefit of its employees, if the plan has total assets in excess of $5 million.
- **Employee benefit plans.** Any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary that is either a bank, a savings and loan association, an insurance company, or a registered investment advisor, or if the plan has total assets in excess of $5 million or, if a self-directed plan, with investment decisions made solely by persons who are Accredited Investors.
- **Business development companies.** Any private business development company.
- **Certain key persons and general partners.** Any director, executive officer, or general partner of the private fund whose securities are being offered.
- **Irrevocable trusts.** Any trust with total assets in excess of $5 million, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a person with the knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment.
- **Entities composed of Accredited Investors.** Any entity in which all the equity owners are Accredited Investors.

  Note that while 35 nonaccredited but sophisticated investors (i.e., investors who do not meet the net worth or income requirements) may be admitted to the private fund under Rule 506, if the advisor is a registered investment advisor and charges an incentive fee or allocation, generally all investors in the private fund must meet the net worth requirements under the "incentive fee rule" as discussed below.[4]

Disclosure requirements. Even though Regulation D does not contain specific disclosure requirements if securities of a private fund are sold only to persons who are Accredited Investors, the anti-fraud provisions of the U.S. securities laws apply. Care must be taken to ensure that the disclosures made to investors include all material facts and do not contain any materially false or misleading statements.

> If securities are sold to persons who are not Accredited Investors, disclosure materials must conform to certain standards that are generally equivalent to those governing disclosures in registered offerings in the U.S.

Resale restrictions. Securities acquired in a Regulation D (and Section 4(2)) private placement in the U.S. are "restricted securities"—they may not be resold by the investor, other than pursuant to registration under the Securities Act or pursuant to exemption from such registration. The private fund must establish that the purchasers of its securities are not purchasing them with a view to distributing them to the public, and that the purchasers understand the resale restrictions under federal securities law. Unrestricted transfers of securities by

purchasers can jeopardize the private placement exemption of a private fund. Consequently, in the subscription agreement, purchasers agree to comply with these resale restrictions and to the placing of a restrictive legend on the certificates representing their securities, if certificates are issued.

Filing requirements. Private funds selling securities in reliance on Regulation D are required to file a notice on Form D with the SEC no later than 15 days after the first sale of securities. Thereafter, they must report material mistakes and certain other changes to the form, and must report annually if the offering is continuing at that time.

Regulation S. Offshore funds generally rely on Regulation S under the Securities Act for an exemption with respect to offers and sales to non-U.S. investors made abroad. Offers and sales to non-U.S. investors under Regulation S need not comply with Regulation D's ban on general solicitation and advertising, but the offering must occur outside the U.S., be made to non-U.S. persons with only incidental U.S. contacts, and be made in such a way as reasonably to preclude redistribution of the securities in the U.S.

State blue sky requirements. State securities laws impose restrictions and filing requirements on the offering of securities to offerees residing within the particular state. Private funds relying on Rule 506 are exempt under section 18 of the Securities Act from these state securities laws' ("blue sky") registration and qualification requirements (but not from state notice and fee requirements). Section 18 prohibits individual states from regulating the content of offering documents or the terms of securities being offered, although state authorities retain jurisdiction to investigate fraud and penalize violators.

Regulation as a "broker" or "dealer" of the private fund and as an "agent" or "salesman" of the advisor or another person making an offering on behalf of the private fund may also be required in some states.

Foreign laws. Private funds must also comply with the relevant laws of each jurisdiction in which their interests are offered and sold. Many offshore jurisdictions have exemptions similar to the private offering exemption found under the Securities Act, but even in those jurisdictions care must be taken to ensure that appropriate filings are made and appropriate legends are included in the private fund's offering documents, if required.

B. Securities Exchange Act of 1934

Exemptions from broker-dealer registration

issuer exemption. The Securities Exchange Act of 1934 ("Exchange Act") requires the registration of securities brokers and dealers. A broker under the Exchange Act is "any person engaged in the business of effecting transactions in securities for the account of others."[5] Generally, private funds trade for their own account and not for the account of others and therefore are not required to register. A dealer under the Exchange Act is "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise."[6] But as an entity that trades securities solely for its own investment account without carrying on a public securities business, a private fund is excepted from the definition of "dealer."[7]

Agent exemption. Officers or directors of the private fund, owners or employees of the investment manager to the private fund, and independent solicitors who place securities of the private fund may be subject to registration in the U.S. as brokers. This can be the case even if no sales load is charged to investors. Using a registered broker-dealer as a placement agent is one way for a sponsoring investment advisor and its employees to avoid broker-dealer registration. Rule 3a4-1 under the Exchange Act deems certain "associated persons" of an issuer of securities not to be brokers, subject to certain conditions. Associated persons relying on this exemption cannot be subject to statutory disqualification (for certain prior bad acts),[8] cannot be compensated by the payment of commissions or other remuneration based directly or indirectly on transactions in securities,

and cannot be an associated person of any broker or dealer. The rule's safe harbor requires that the associated person's activities meet one of the following:

- The person's activities are restricted to sales of securities of the private fund to registered broker-dealers, registered investment companies, insurance companies, banks, trust companies, or registered advisors who have investment direction (given in writing) or are acting as trustees;
- The person's activities in selling securities are sporadic (the person does not generally participate in selling an offering of securities for any issuer more than once every 12 months); the person has other substantial duties with or on behalf of the issuer other than in connection with transactions in securities; and the person has not been associated with a broker-dealer for the preceding 12-month period; or
- The person's activities are confined to certain ministerial and clerical work involved in effecting transactions.

Exchange Act issuer registration. Section 12(g) of the Exchange Act subjects issuers whose securities are traded by use of U.S. mail or any other means or instrumentality of U.S. interstate commerce that meet certain total asset levels and number of record-holder thresholds to registration and public reporting under the Exchange Act. If a private fund has total assets of more than $10 million and a class of equity securities held of record by either (1) 2,000 persons or (2) 500 persons who are not Accredited Investors, it will be required to register the security with the SEC. Private funds generally fall below these thresholds for registration.

An offshore fund may qualify under Rule 3b-4 under the Exchange Act as a "foreign private issuer"[9] and would be exempt from registration under the Exchange Act provided that any "class" of securities issued has fewer than 300 holders resident in the U.S.[10]

C. Investment Company Act of 1940

An issuer is an "investment company" under the Investment Company Act of 1940 (the "Investment Company Act") when it "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities."[11] Unless exempt from the Investment Company Act, an investment company must register its securities with the SEC and conduct its operations within the rigorous constraints of the Investment Company Act, including, among other things, requirements on the minimum number of disinterested directors composing the board, minimum amount of initial seed capital, prohibitions on certain affiliated transactions with the private fund, maximum use of leverage, and liquidity.

Section 7(d) of the Investment Company Act prohibits an offshore fund from using the mails or any means or instrumentality of U.S. interstate commerce to make a public offering of its shares.

In order for a private fund not to be considered an "investment company" under the Investment Company Act, the private fund will usually satisfy the requirements of either Section 3(c)(1) of the Investment Company Act (the "100 or fewer investors" exemption) or Section 3(c)(7) of the Investment Company Act (the "qualified purchaser fund" exemption).

3(c)(1) funds. To qualify under the "100 or fewer investors" exemption:

- Interests in the private fund (which constitute "securities" for purposes of the federal securities laws) may not at any time be owned beneficially by more than 100 persons within the meaning of Section 3(c)(1) of the Investment Company Act;[12] and
- The private fund may not engage in a public offering of the securities within the meaning of the Securities Act (see discussion in section II.A above).

For purposes of the "100 or fewer investors" requirement, each person having a beneficial

interest in the private fund, whether directly or indirectly, is included in the computation. In order to permit the private fund to make and maintain an accurate computation of and retain its control over the number of beneficial owners, each investor will be required either (1) to represent in a subscription agreement that the investor is the sole owner of all the funds contributed by the investor and that no other person (other than his or her spouse) will have any beneficial interest in the private fund interest, or (2) if others are to share in the interest, to deliver a representation describing in detail all such interests of others prior to the person becoming an investor. An investor that is a trust, corporation, partnership, or similar entity will generally be counted as a single beneficial owner, unless the entity is an investment entity (e.g., a family investment partnership or a fund of funds) that owns 10% or more of the voting securities of the private fund.[13] In those cases, each beneficial owner of the 10% owner of the private fund counts as an owner of the private fund. Notwithstanding the above, an entity may, in certain additional circumstances, be counted as more than a single beneficial owner. For example, each stockholder or partner of a corporation or partnership would be considered to be a beneficial owner of an interest in the private fund if the corporation or partnership were formed for the specific purpose of investing in the private fund or otherwise used as a device to avoid the application of the "100 or fewer investors" requirement of Section 3(c)(1) of the Investment Company Act.[14]

Knowledgeable employees of a private fund or its investment advisor are excluded for purposes of determining the number of beneficial owners investing in the private fund.[15] Furthermore, in counting beneficial owners, private funds may continue to count as beneficial owners the transferor of an interest in the private fund to the extent that the transferees received their interests from the transferor as a gift or bequest or as a result of separation, divorce, death, or other involuntary event.[16]

Integration. Whenever an investment advisor seeks to establish more than one private fund in reliance on section 3(c)(1), the advisor must consider whether the additional private fund or funds could be integrated with its existing fund or funds—that is, treated as one fund for purposes of the "100 or fewer beneficial owners" requirement.[17]

> The SEC has stated that separate private funds should be integrated for purposes of section 3(c)(1) when an investor qualified to invest in both private funds would view the two funds as not being materially economically different.[18]

In determining whether funds are different, the SEC analyzes each fund's investment objectives, types of portfolio securities, and risk and return characteristics.[19] Variations in the makeup of the portfolio of each fund are relevant. In addition, funds designed to accommodate the different tax needs of different types of investors may not be integrated, even though managed with similar investment objectives by the same advisor.[20]

3(c)(7) funds. To qualify under the "qualified purchaser fund" exemption:

- Interests in the private fund must be owned only by "qualified purchasers" within the meaning of Section 3(c)(7) of the Investment Company Act (generally individuals that own "Investments" [see "Determination of 'Investments'" below] of at least $5,000,000 or entities [other than family-owned companies] that own "Investments" of at least $25,000,000); and
- The private fund may not engage in a public offering of its securities within the meaning of the Securities Act (see discussion in section II.A above).

"Knowledgeable employees" of the investment advisor are treated as qualified purchasers for purposes of the "qualified purchaser fund" exemption.[21]

Transferees of qualified purchasers (to the extent that the transferees received their interests from the qualified purchaser as a gift or bequest or as a result of separation, divorce, death, or another involuntary event) are treated for the purpose of the transferred interest as qualified purchasers.[22]

Any company is a qualified purchaser if each beneficial owner of the company's securities is a qualified purchaser.[23]

An offshore fund relying on section 3(c)(7) will only have to "reasonably believe"[24] that all its owners that are U.S. persons are qualified purchasers.[25] The non-U.S. owners of the offshore fund need not be qualified purchasers. Furthermore, a fund relying on section 3(c)(7) will not be integrated with a fund relying on section 3(c)(1).[26]

D. Investment Advisers Act of 1940

Registration. An investment advisor with regulatory assets under management[27] of more than $25 million must register as an investment advisor with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act") unless it (1) meets the definition of a "Mid-Sized Investment Adviser"[28] or (2) qualifies for an exemption or exclusion. Investment advisors that manage only private funds (i.e., no separately managed accounts) and have regulatory assets under management of less than $150 million generally may rely on the private fund advisor exemption.[29] Certain exempt investment advisors, such as private fund advisors, may still have limited reporting obligations with the SEC. An investment advisor with regulatory assets under management of $25 million or less is prohibited from registering with the SEC.

Determination of 'Investments'

When determining an investor's ownership of "Investments," the following general rules are applicable:

1. Investments should be valued at either their fair market value as of the most recent practicable date or cost.
2. Investments include investments held jointly with the investor's spouse.
3. Investments include investments held in any IRA, 401(k), or similar retirement account directed by the investor and held for the investor's benefit.
4. The principal amount of any outstanding debt, including margin loans, incurred by the investor (or any of the owners of the investor) to acquire or for the purpose of acquiring the Investment must be *excluded* from the value of each investment.
5. Investments include the following:
   - ✓ Securities that are publicly traded and listed on a U.S. national securities exchange or traded on Nasdaq
   - ✓ Shares in registered investment companies such as mutual funds and money market funds
   - ✓ Interests in private investment companies such as hedge funds, commodity pools, and similar private investment companies
   - ✓ Cash and cash equivalents (including foreign currencies) held for investment purposes
   - ✓ Real estate held for investment purposes
   - ✓ Shares of nonpublic companies that have total shareholder equity of $50 million or more
   - ✓ Commodity interests, including commodity futures contracts and options thereon, swaps, and other financial contracts
6. Investments **DO NOT** include the following:
   - ✓ Jewelry, artwork, antiques, and collectibles
   - ✓ Investments held in retirement accounts for which the investor does not make the investment decisions (e.g., an employer retirement plan the investment decisions of which are not directed by the investor)
   - ✓ Shares in a nonpublic company in which the investor has a controlling interest (presumed to exist if the investor owns more than 25% of the voting interests)

Incentive compensation. Although Advisers Act Section 205(a)(1) generally prohibits the payment of performance fees to advisors registered under the Advisers Act, Section 205(b)(5) permits the receipt of performance fees from "a person who is not a resident of the United States." Registered advisors may also charge qualified purchaser funds and certain employees performance fees.

Under the Advisers Act, a registered investment advisor may receive an incentive fee or an incentive allocation of profits if it complies with Rule 205-3 under the Advisers Act. Rule 205-3 sets forth the conditions that must be met for a registered investment advisor to receive an incentive fee or an incentive allocation of profits from a "Qualified Client." Generally, under Rule 205-3, each investor of the private fund would have to have $1,000,000 invested with the investment advisor, or have a net worth (including the entire value of property held jointly with his or her spouse) of more than $2 million, but excluding the value of his primary residence.[30] Each of the equity owners of an investment company registered with the SEC or excepted from the definition by Section 3(c)(1) must satisfy one of the tests set forth above.

State and foreign law requirements. Certain states and foreign jurisdictions may require investment advisors to register or notice file as an investment advisor with them as a result of accepting resident investors into a private fund.

E. Commodities Exchange Act

Investments in commodity interests; CPO/CTA registration. If the private fund intends to invest in commodity options, certain swaps,[31] certain foreign exchange transactions and futures (including security futures), or other instruments deemed "commodity interests," the private fund would likely be considered a commodity pool under the Commodity Exchange Act ("CEA"). Further, the investment advisor may be required to register as a commodity pool operator ("CPO") and/or a commodity trading advisor ("CTA") with the Commodity Futures Trading Commission (the "CFTC").

Recent Developments Affecting CPOs and CTAs

A number of recent statutory and regulatory changes have affected CPOs and CTAs. The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the CEA, the Securities Act, and the Exchange Act to address swap agreements and divided jurisdiction between the CFTC and the SEC based on the nature of the instrument underlying a swap agreement. In July 2012, the CFTC and the SEC finalized the definitions of "swaps," "security-based swaps," and "mixed swaps." Additionally, the CFTC rescinded Rule 4.13(a)(4) under the CEA, thereby removing an exemption from CPO registration relied on by many private fund advisors engaging in trading in futures and other CFTC-regulated instruments. Advisors currently relying on this exemption may not rely on the exemption after Dec. 31, 2012. These statutory and regulatory changes expanded the universe of entities that may meet the definition of CPO or CTA and limited the entities that may claim an exemption from registering as a CPO or CTA. The CFTC also imposed systematic risk reporting requirements on CPOs and CTAs related to the commodity pools and accounts to which they provide commodity trading advice.

CPO/CTA definitions. The CEA defines a "commodity pool operator" as any person engaged in a business that is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or other property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests.

A "commodity pool" is any investment trust, syndicate, or other form of enterprise operated for the purpose of trading in commodity interests.

Many private fund advisors will fall within the definition of a CPO because the trading of even a single commodity interest will bring the advisor within the definition of a CPO. Absent an available exemption, any person not otherwise excluded who meets the definition of CPO must register with the CFTC under the CEA.[32]

The CEA defines a "commodity trading advisor" as any person who (1) for compensation or profit, engages in the business of advising others, either directly or indirectly or through publications, writings, or electronic media, as to the value of, or the advisability of trading in, commodity interests, or (2) for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the activities set forth in (1) above.

Absent an exemption, any person meeting the definition of CTA, and not otherwise excluded, must register with the CFTC under the CEA.

CPO de minimis exemption. Rule 4.13(a)(3) provides an exemption from registration as a CPO for any advisor who operates a commodity pool engaging in limited commodity interest trading that is not marketed as a vehicle for trading in commodity interests. Specifically, the exemption is available to advisors who operate private funds: (1) whose participants are, at the time of investment, Accredited Investors, certain family trusts formed by Accredited Investors, non-U.S. Persons, knowledgeable employees or persons who are Qualified Eligible Persons[33] ("QEPs") that do not need to satisfy the Portfolio Requirement (as described below), and non-natural persons that are QEPs (regardless of whether they must satisfy the Portfolio Requirement); and (2) whose commodity interest positions (regardless of whether those positions were established for bona fide hedging purposes or otherwise) meet either of the following trading limitations at all times:[34]

- The aggregate initial margin and premiums required to establish commodity interest positions, together with the required minimum security deposit for retail forex,[35] will not exceed 5% of the liquidation value of the private fund's portfolio after taking into account unrealized profits and unrealized losses on those positions (provided that, with respect to an option that is in-the-money at the time of purchase, the in-the-money amount may be excluded in computing the 5%); or
- The aggregate net[36] notional value[37] of the positions will not exceed 100% of the liquidation value of the private fund's portfolio after taking into account unrealized profits and unrealized losses on the positions.

The "**Portfolio Requirement**" requires certain categories of QEPs to (1) own securities and other investments with a market value exceeding $2 million, (2) have on deposit at a futures commission merchant (an "FCM") in the last six months more than $200,000 in exchange-specified initial margin and option premiums (together with required minimum security deposit for retail forex transactions—relevant if the QEP is not an "eligible contract participant"), or (3) have a combination of securities/investments and FCM deposits, the percentages of which relative to the required amounts in (1) and (2) above equal 100% (e.g., securities and investments of $1 million and FCM deposits of $100,000).

In addition, in order to rely on the Rule 4.13(a)(3) exemption, the pool must also be offered pursuant to Regulation D of the Securities Act of 1933 and not (1) marketed as a vehicle for trading in the commodity futures or commodity options markets or (2) marketed to the public in the U.S.[38]

There are two other exemptions provided by Rule 4.13(a) that will likely have limited application to private fund advisors:[39]

Application of the de minimis exemption to fund-of-funds advisors. Before the CFTC's recent amendments, Appendix A to Part 4 of the CFTC regulations clarified how the trading limitations of Rule 4.13(a)(3) applied to fund-of-funds advisors. This Appendix was removed from the CFTC's regulations, and the CFTC is expected to issue revised guidance regarding how a fund-of-funds advisor should apply the trading limitations of Rule 4.13(a)(3). In the interim, however, the CFTC has indicated in a recently issued FAQ that advisors may continue to rely on the guidance previously set forth in Appendix A until the CFTC adopts revised guidance.

Claiming the de minimis exemption. Any advisor that claims an exemption under Rule 4.13(a)(3) will be required to make an initial filing with the NFA and maintain books and records relating to its commodity interest trading. The advisor will also be subject to any special calls that the CFTC may impose relating to eligibility for the exemption and compliance with it. In addition, each advisor claiming an exemption under Rule 4.13(a)(3) must make an annual filing with the NFA, affirming the advisor's eligibility to rely on the exemption.

In addition, if CFTC registration is required, unless the private fund meets the requirements of CFTC Rule 4.7 (i.e., that all limited partners are QEPs), the offering memorandum or similar disclosure document of the private fund would have to be approved by the CFTC.

CTA de minimus exemptions. An advisor otherwise meeting the definition of a CTA is exempt from registration if it:

- Provides commodity trading advice only to commodity pools for which it is the CPO (whether registered or exempt (CFTC Rule 4.14(a)(4));
- Is a registered investment adviser whose business does not consist of primarily acting as a CTA and does not advise any fund that primarily trades commodity interests (CEA Section 4m(3)); or
- Has provided advice to 15 or fewer persons during the last 12 months and does not hold itself out to the public as a CTA (CEA Section 4m(1) and CFTC Rule 4.14(a)(10)).[40]

CFTC Rule 4.14(a) provides additional exemptions from registration as a CTA that will likely have limited application to private fund advisors.[41]

F. Employee Retirement Income Security Act of 1974

Calculating ERISA's 25% Threshold.

Private funds and their advisors need to be concerned with the possible application of ERISA's fiduciary rules to their funds and themselves.

Section 3(42) of ERISA and U.S. Department of Labor ("DOL") regulations provide that a private fund and its advisor will be subject to ERISA's fiduciary rules if investment in the private fund by "Benefit Plan Investors" is 25% or more of the value of any class of its equity interests (the "25% Threshold"). When a private fund reaches the 25% Threshold, it may be prohibited from making certain investments, and its advisor will be a fiduciary to each investing employee benefit plan.

"Benefit Plan Investors" include U.S. corporate and union pension plans (e.g., 401(k) plans and Taft-Hartley plans) and other private funds, group trusts, and certain insurance company accounts that hold plan assets, as well as those assets that are subject to the prohibited transaction provisions of the Internal Revenue Code (e.g., IRAs, Keoghs, SEPs, and medical savings accounts).

Exceeding ERISA's 25% Threshold. As a practical matter, exceeding the 25% Threshold is an option only for registered investment advisors. There are three primary areas of concern for private funds that exceed the 25% Threshold:

- **Prohibited transactions.** Generally, a transaction between the fund and any party-in-interest to any ERISA investor in the fund is a prohibited transaction (a "PT"). A party-in-interest includes the fund's investment advisor, the fund's service

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providers, and a fiduciary of any ERISA investor or service provider to any ERISA investor. While PTs are often highly restrictive, there are several exemptions available to allow an advisor to pursue its investment strategy. In particular, advisors often rely on the exemption for qualified professional asset managers ("QPAMs") to provide relief from ERISA's prohibited transaction provisions.

- **ERISA compliance.** The advisor of a private fund exceeding the 25% Threshold will also be subject to other compliance obligations, including:
    - A requirement to be covered by an ERISA "fidelity bond"
    - A requirement to either file an information return with the DOL ("Form 5500") as a "direct filing entity" or provide transaction, asset, and expense information to each ERISA investor so that investor can include this information on its Form 5500
    - A requirement to maintain custody of fund assets in the U.S. or, if the fund invests in foreign securities and holds them offshore, a requirement to comply with certain ERISA regulations
- **Liability.** The advisor of a fund exceeding the 25% Threshold will also be subject to the "prudent expert" standard of care imposed by ERISA on fiduciaries (so that a gross negligence standard may not be used). The principals of the advisor will also be personally liable for any breaches of the fiduciary duties to an ERISA investor and will not be able to claim indemnification from the private fund for that breach.

III. Who Will Be the Manager?

Establishment of new general partner/managing member entity. An investment advisor to private funds often considers organizing another entity to serve as the general partner of a domestic fund organized as a limited partnership or to serve as the managing member of a domestic fund formed as a limited liability company.

Reasons for creating a separate general partner managing member (hereafter referred to as a "general partner") include optimizing tax treatment for principals of the advisor, limiting the advisor's liability to counterparties of the fund, and providing greater flexibility in structuring compensation arrangements with key personnel.

Attention should be given to state and local (e.g., New York City) taxation of the general partner and its owners.

Establishment of new investment advisor entity. In certain instances the principals of an investment advisor will decide to organize a separate entity to serve as an investment advisor to the private fund. This course is generally taken to segregate income from the private fund to facilitate flexibility in compensation arrangements with key personnel and to provide a ready mechanism to spin off the private fund activity.

IV. Private Fund Structures

Preliminary considerations. Private funds are organized to be tax efficient for the investor in the fund.

Types of investors; tax issues. Investors in private funds are generally divided for tax purposes into three categories: U.S. taxable investors (e.g., individuals and U.S. corporations), U.S. tax-exempt investors (e.g., not-for-profit companies and employee benefit plans), and non-U.S. investors.

U.S. taxable investors. U.S. taxable investors usually favor investing in domestic funds that are treated for U.S. income tax purposes as partnerships. Under the U.S. federal income tax regime, partnerships are treated as transparent because income tax is imposed not on the entity but on the investors, whether or not the income was paid out to them.

U.S. tax-exempt investors. U.S. tax-exempt investors usually favor investing in offshore funds (formed in tax-haven jurisdictions) that are treated for U.S. income tax purposes as corporations.

Under the U.S. federal income tax regime, assuming a U.S. tax-exempt investor does not borrow money or otherwise use leverage to purchase its interest in the offshore fund, the U.S. tax-exempt investor should not realize "unrelated debt-financed income" as defined in Internal Revenue Code ("IRC") section 514 or "unrelated business taxable income" as defined in IRC section 512 with respect to its investment in the offshore fund. The investment activity and operations of the offshore fund are intended to be conducted so that it is not deemed to be engaged in a U.S. trade or business; its securities and derivatives trading activities should thus not be subject to regular U.S. federal income tax on its trading profits to the extent those securities or derivatives are not classified as "United States real property interests" within the meaning of IRC section 897, although there would be a 30% withholding tax applicable to dividends and certain interest income considered to be from sources within the U.S.

Non-U.S. investor. Non-U.S. investors usually favor investing in offshore funds (formed in tax-haven jurisdictions) that are treated for U.S. income tax purposes as corporations. Non-U.S. investors generally desire freedom from U.S. tax filings, which ownership of a foreign corporate vehicle provides. By purchasing interests in the offshore fund, non-U.S. natural persons also avoid the potential liability for U.S. federal estate tax if the fund invests in securities of U.S. issuers.

Basic fund structures; advantages and disadvantages.

Master feeder or side by side? This is a fundamental decision when structuring private investment funds for U.S. and non-U.S. investors.

In a typical master-feeder structure, a domestic fund (open to U.S. taxable investors) and an offshore fund (open to U.S. tax-exempt and non-U.S. investors) invest all their assets in an offshore "master" entity taxable for U.S. federal income tax purposes as a partnership. All the trading is conducted in the master fund, and the feeder vehicles participate pro rata in the trades. In a typical side-by-side structure, a domestic fund and an offshore fund are separate, stand-alone entities that trade alongside each other. While both structures are designed to allow for investment by U.S. taxable and U.S. tax-exempt investors, as well as non-U.S. investors, each structure has distinct advantages that should be considered.

The main advantages of a master-feeder structure are as follows:

- Eliminates the need to split tickets or engage in "rebalancing" trades
- Eliminates the need to enter into duplicative documentation with counterparties
- May lend itself to easier application of risk management and other analytics
- Smooths out performance differences
- Helps ensure that a single pool of assets will be available as collateral for credit lines or to otherwise satisfy the concerns of counterparties
- A single pool of assets may make it easier to meet "qualified institutional buyer" or other asset-based requirements
- Can increase an investment strategy's overall ERISA capacity
- In certain circumstances, may offer better opportunities for leverage than a stand-alone domestic fund

The main advantage of a side-by-side structure are as follows:

- The advisor can manage for tax efficiency in the domestic fund without disadvantaging the other categories of investors (e.g., a 12-month holding period of securities is preferable for U.S. taxable investors, but irrelevant to U.S. tax-exempt or non-U.S. investors).
- If the funds are relying on Section 3(c)(1) of the Investment Company Act, in a side-by-side structure a total of 200 U.S. beneficial owners is generally permitted (100 U.S. taxable beneficial owners in the domestic fund and 100 U.S. tax-exempt beneficial owners in the offshore

fund), compared with a maximum of 100 U.S. beneficial owners in a master-feeder structure.

- A stand-alone domestic fund may be eligible for certain tax-treaty benefits, whereas a master fund itself is generally not eligible.
- In the case of a fund of funds, a side-by-side structure avoids disadvantageous tax issues for U.S. taxable investors (e.g., arising from investments in an underlying manager's offshore funds), for non-U.S. investors (e.g., arising from investments in an underlying manager's domestic funds if they generate income effectively connected to a U.S. trade or business), or 3(c)(1) counting issues and/or "qualified purchaser" requirements for non-U.S. investors (i.e., if the structure involves a U.S. master fund investing in underlying managers' U.S. partnerships).

Ultimately, when making this decision, the advisor will have to decide which structure best suits its strategy, target investors, and other relevant factors.

V. Compliance Considerations

Operating private funds poses challenges to the investment advisor's organization, and care must be taken at the outset and periodically thereafter to ensure that the advisor has identified these risks and conflicts of interest and made appropriate modifications to the advisor's compliance program.

Key Documents

Fund Documents

The following documents and forms are typically prepared and, if required, filed with the appropriate authorities in connection with the launch of a private fund:

- ✓ Domestic, offshore, and, if applicable, master fund (entity) formation/qualification documents (including memorandum of association and articles of association for offshore fund and possibly master fund)
- ✓ Tax ID numbers and other tax filings (including possible filing of IRS Form 8832 [check-the-box for entity elective classification] for master fund if a corporation)
- ✓ Domestic fund limited partnership agreement or limited liability company agreement
- ✓ Offshore fund minutes of board of directors
- ✓ Master fund limited partnership agreement or, if company, minutes of board of directors
- ✓ Offering documents (offering memorandum and subscription agreement(s) for domestic fund and offshore fund)
- ✓ Investment management agreement(s)
- ✓ Prime brokerage/ISDA documents
- ✓ Bank account(s) opening documentation
- ✓ Fund administration agreement, if applicable
- ✓ Initial form Ds, blue sky, CFTC, and other regulatory filings (including with appropriate foreign authorities)
- ✓ Initial marketing materials (e.g., DDQ and PowerPoint presentation)

General Partner/Management Company Documents

If the investment advisor is going to establish new entities to serve as general partner and investment advisor to the private funds, the following will be necessary:

- ✓ General partner/management company entity formation/qualification documents
- ✓ Limited liability company agreements for each entity
- ✓ Tax ID numbers
- ✓ Regulatory filings, if appropriate

A review of the compliance program may include the following questions:

- Does the private fund have a different fee structure than the advisor's managed accounts? Different fee structures may create a conflict for the advisor, which weighs in favor of the advisor providing a heightened review of comparative performance and investment allocations.
- Are the advisor's custody procedures sufficient given the fact that the advisor, by virtue of being (or having a related person be) the general partner of a private fund, will be considered to have "custody" of client assets within the meaning of Advisers Act Rule 206(4)-2? Does the capitalization or composition of the board of the offshore fund result in the advisor being deemed custodian of client assets?
- Are all the thresholds for the various federal securities laws, commodities laws, and ERISA being monitored for compliance? If those responsibilities have been outsourced to a third party, e.g., an administrator, is the advisor periodically monitoring that service provider?
- Are any access persons acquiring interests in the private fund, and, if so, have those transactions been preapproved by the appropriate persons of the advisor as an acquisition of securities in a "limited offering" under the advisor's Code of Ethics (as required by Advisers Act Rule 204A-1(c))? Will the level of participation by the advisor and its affiliates result in any transaction between the private fund and another client of the advisor being deemed a "principal" trade under Advisers Act section 206(3)? If so, are there sufficient measures in place to ensure that appropriate consent is obtained before each "principal" trade?
- Will the advisor be required to register or notice file as an advisor with any state as a result of any resident of that state becoming an investor of the fund?
- Will any changes to the advisor's Compliance Manual or Code of Ethics be necessary to accommodate the advisor's management of the private fund and to address any risks or conflicts of interest raised by this activity?
- Do the private fund's offering documents conform to the advisor's actual management of the private fund, and are they consistent with disclosures made in the advisor's other documents, (e.g., the advisor's Form ADV and marketing material)? Is that documentation updated accordingly to reflect material changes?
- Has the advisor's Form ADV been revised to reflect the management of the private fund (including Item 7 and Section 7 of Schedule D)? Is the advisor required to complete and file SEC Form PF (for reporting information on private funds when a registered investment advisor has at least $150 million in regulatory assets under management attributable to private funds) and/or related CFTC forms?

VI. Conclusion

Private funds offer the advisor an expanded platform and offering, but careful planning should be undertaken before launch to ensure that the advisor has structured the fund properly from a tax and regulatory perspective and has reviewed and revised its compliance program accordingly.

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[1] Section 201(a) of Jumpstart Our Business Startups Act, Pub. L. No. 112-116, 126 Stat. 306 (Apr. 5, 2012) (the "JOBS Act") requires the SEC to revise Rule 506 to remove the ban on general solicitation and general advertising for offerings made pursuant to Rule 506, provided that all purchasers of such securities are Accredited Investors. The SEC has proposed such rules, but they have not yet been adopted.

[2] If a private fund relies on the 4.13(a)(3) exemption available under the Commodity Exchange Act, that fund will be more limited in its ability to admit any non-accredited investors.

[3] In calculating net worth, an individual must include as a liability the amount of indebtedness secured by the individual's primary residence that is incurred (i) at any time and is in excess of the estimated fair market value of such residence, or (ii) within 60 days before the admission date to the private fund (other than as a result of the acquisition of the residence).

[4] See note 1.

[5] Exchange Act § 3(a)(4).

[6] Exchange Act § 3(a)(5).

[7] See, e.g., Letter from Charles M. Horn, Division of Market Regulation, SEC, to David R. Burton, President, Burton Securities, dated Dec. 5, 1977; *Davenport Management, Inc.*, SEC No-Action Letter (pub. avail. April 13, 1993) ("Davenport").

[8] As set forth in Exchange Act § 3(a)(39).

[9] Under Rule 3b-4 of the Exchange Act, the term "foreign private issuer" means any foreign issuer other than a foreign government except an issuer meeting the following conditions:

1. More than 50% of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; and
2. Any of the following:
   (i) The majority of the executive officers or directors are United States citizens or residents;
   (ii) More than 50% of the assets of the issuer are located in the United States; or
   (iii) The business of the issuer is administered principally in the United States.

Therefore, if 50% or more of an offshore fund's voting securities are held of record outside of the U.S., the U.S. citizenship/residency, asset, and business location administration tests do not apply.

[10] Exchange Act Rule 12g3-2(a).

[11] Investment Company Act § 3(a)(1). Even an issuer that does not meet this definition may be an "investment company" under the Investment Company Act if it engages in the business of investing, reinvesting, owning, holding, or trading securities and it owns or proposes to acquire investment securities exceeding 40% of its total assets. Investment Company Act § 3(a)(3).

[12] An offshore fund need not count non-U.S. persons toward the "100 or fewer beneficial owners" requirement. See *Touche Remnant & Company*, SEC No-Action Letter (pub. avail. Aug. 27, 1984) ("Touche"). Nevertheless, an offshore fund may count as non-U.S. holders those persons who relocated to the U.S., provided that certain conditions are met. *Investment Funds Institute of Canada*, SEC No-Action Letter (pub. avail. March 4, 1996) ("IFIC").

[13] The ownership threshold for purposes of this look-through provision relates to "voting securities" as defined in section 2(a)(42) of the Investment Company Act and must be tested on an ongoing basis. The SEC may view an interest in a private investment company a "voting security" even if the security lacks general voting privileges under certain circumstances, such as when the position held by the investor is sufficiently large to enable the investor to exert commercial influence on company matters or the investor. See *Standish Equity Investments, Inc.* (pub. avail. Dec. 15, 1993). See also *Weiss, Peck & Greer Venture Associates II* (pub. avail. Apr. 10, 1990); *Indiana Hospital Ass'n Investment Funds, L.P.* (pub. avail. Oct. 15, 1985); Kohlberg Kravis Roberts & Co., Inc. (pub. avail. Sept. 9, 1985).

[14] Section 48(a) of the Investment Company Act prohibits attempting to circumvent the provisions of the Investment Company Act by indirect means. 15 U.S.C. section 80a-48(a). If more than 40% of an entity investor's assets are invested in a particular private fund or if beneficial owners of the entity investor can opt in or out of particular investments, look through may be required. *Six Pack*, SEC No-Action Letter (pub. avail. Nov. 13, 1989); *Handy Place Investment partnership*, SEC No-Action Letter (pub. avail. July 19, 1989).

[15] 17 C.F.R. § 270.3c-5. Rule 3c-5 under the Investment Company Act provides a definition of "knowledgeable employees."

[16] 17 C.F.R. § 270.3c-6.

[17] 15 U.S.C. § 80a-48(a).

[18] *PBT Covered Option Fund*, SEC No-Action Letter (pub. avail. Feb. 17, 1979); *Equitable Capital Management Corp.*, SEC No-Action Letter (pub. avail. Dec. 16, 1991).

[19] *Oppenheimer Arbitrage Partners, L.P.*, SEC No-Action Letter (pub. avail. Dec. 26, 1985).

[20] *Shoreline Fund, L.P.*, SEC No-Action Letter (pub. avail. April 11, 1994).

[21] 17 C.F.R. § 270.3c-5.

[22] 17 C.F.R. § 270.3c-6.

[23] 17 C.F.R. § 270.2a51-3(b).

[24] 17 C.F.R. § 270.2a51-1(h).

[25] *Goodwin, Procter & Hoar*, SEC No-Action Letter (pub. avail. Feb. 28, 1997); IFIC.

[26] 15 U.S.C. § 80a-3(c)(7)(E).

[27] Regulatory assets under management includes the value of securities portfolios for which the advisor provides continuous and regular supervisory or management services, including any uncalled committed capital without deducting any outstanding indebtedness or other accrued but unpaid liabilities.

[28] Section 203A of the Advisers Act provides an exemption from registration under the Advisers Act for any investment advisor that (i) is required to be registered and is subject to examination as an investment advisor in the state in which it maintains its principal office and place of business, and (ii) has regulatory assets under management of no more than $100 million (or such higher amount as the SEC specifies by rule). Advisers to SEC-registered funds and business development companies are excluded.

[29] Section 203(m) of the Advisers Act; Rule 203(m)-1 under the Advisers Act.

[30] See note 3.

[31] Swaps are divided into three categories: securities-based swaps, other swaps, and mixed swaps. Securities-based swaps are regulated by the

SEC, other swaps are regulated by the CFTC, and the SEC and the CFTC share authority over mixed swaps. Swap contracts that are tied to a single loan, a single security, or a narrow-based index will generally be treated as security-based swaps. Most other swap contracts (including certain credit default swaps and total return swaps) will be classified as swaps. Many foreign exchange and currency derivatives are currently classified as swaps, however, the Department of the Treasury issued an order that excludes foreign exchange forwards and foreign exchange swaps from regulation as swaps (except for certain reporting, business conduct standards, and anti-manipulation purposes).

A narrow-based index is an index that meets one of the following conditions: (i) the index has nine or fewer component securities; (ii) a component security composes more than 30% of the index's weighting; (iii) the five highest-weighted component securities in the aggregate compose more than 60% of the index's weighting; or (iv) the lowest-weighted component securities composing, in the aggregate, 25% of the index's weighting have an aggregate dollar value of average daily trading volume of less than $50 million (or in the case of an index with more than 15 component securities, $30 million).

[32] The general partner, managing member, or board of directors of a commodity pool can avoid registration as CPO if it properly delegates its rights and obligations as a CPO to a registered CPO, provided that each party agrees to be jointly and severally liable. See Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions—CPO/CTA: Amendments to Compliance Obligations, Aug. 14, 2012.

[33] A "Qualified Eligible Person" is a person who satisfies the suitability requirements described in Rule 4.7 of the CFTC regulations. There are two general categories of QEPs: (i) accredited investors (who must satisfy a Portfolio Requirement to qualify) and (ii) qualified purchasers, knowledgeable employees, and non-U.S. Persons (who are not required to satisfy a Portfolio Requirement to qualify). Non-U.S. Person is defined in CEA Rule 4.7(a)(1)(iv).

[34] The CFTC staff has indicated in a FAQ published in August 2012 that under Regulation 4.13(a)(3), a CPO is required to be in compliance with the trading thresholds only at the time a position is established, and is not otherwise required to reconfigure its portfolio to comply with the limits.

[35] If the private fund has at least $10 million in assets, its off-exchange foreign currency transactions are not considered "retail forex" and thus not counted toward the 4.13(a)(3) trading limits.

[36] The advisor may net (i) futures contracts with the same underlying commodity across designated contract markets and foreign boards of trade and (ii) swaps cleared on the same designated clearing organization, where appropriate.

[37] Notional value is computed by multiplying the number of contracts by the size of the contract, in contract units (taking into account any multiplier specified in the contract), by the current market price per unit. For options on futures, multiply the number of contracts by the size of the contract, adjusted by its delta, in contract units (again taking into account any multiplier specified in the contract), by the strike price per unit. For each retail forex transaction, calculate the value in U.S. dollars of such transaction at the time the transaction was established, excluding the value in U.S. dollars of offsetting long and short transactions. For both cleared and uncleared swap transactions, the notional value is the amount reported by the reporting counterparty as the notional amount of the swap under Part 45 of the CFTC's regulations.

[38] The Jumpstart Our Business Startups Act (the "JOBS Act"), which was signed into law on April 5, 2012, instructed the SEC to revise its rules to remove the prohibitions against general solicitation and general advertising in connection with many offers and sales of securities made pursuant to Regulation D. The JOBS Act did not instruct the CFTC to make any similar changes to its regulations.

[39] Rule 4.13(a)(1) provides an exemption to advisors who (a) do not receive any compensation for operating a fund (other than reimbursement for ordinary operating expenses), (b) operate only one fund at a time, (c) are not otherwise required to register with the CFTC and are not a business affiliate of any person required to register, and (d) do not (and all other persons involved with the fund do not) advertise on behalf of the fund. Family offices may be able to rely on this exemption. Rule 4.13(a)(2) provides an exemption to advisors who operate funds for which (a) the aggregate gross capital contributions for all funds do not exceed $400,000 and (b) none of the funds have more than 15 participants at any time.

[40] For purposes of counting the 15 clients, it is not necessary to look-through to the underlying owners of entities that receive commodity interest advice based on its investment objectives rather than the individual investment objectives of the owners. If the CTA's principal place of business is outside the U.S., only U.S. residents must be counted as clients. If, however, the CTA's principal place of business is in the U.S., all clients must be counted. See CFTC Rule 4.14(a)(10).

[41] One of these exemptions, CFTC Rule 4.14(a)(8), is for securities investment advisers (registered or exempt) who (i) provide commodities advice as solely incidental to their securities advice, (ii) provide such advice only to certain qualifying entities, including otherwise-regulated entities (e.g., registered investment companies that meet the conditions of Rule 4.5, banks, insurance companies, ERISA plans) and the operators of 4.13(a)(3)-exempt funds, and (iii) do not otherwise hold themselves out to the public as CTAs. Unlike the other exemptions from CTA registration, this exemption is not self-effectuating and requires a filing on the NFA website and compliance with limited disclosure and recordkeeping obligations. There are several other exemptions from CTA registration in Rule 4.14 that are beyond the scope of this article.

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