

THE PRIVATE FUNDS REPORT

Special 10th Anniversary Edition

A publication of the Investment Management Group



INTRODUCTORY GUIDE TO PRIVATE FUNDS AND THEIR MANAGEMENT COMPANIES

INTRODUCTION

Marking the tenth anniversary of our newsletter, *The Private Funds Report*, we are publishing this special issue that compiles a number of articles covering topics that have appeared in past volumes of the newsletter (updated to reflect subsequent changes in the law). We hope that this issue of *The Private Funds Report* will be a useful guide that highlights major issues managers of private investment funds should consider when forming and operating a private investment fund and a management company.

TABLE OF CONTENTS

	Page
I. PRIVATE FUND CONSIDERATIONS.....	2
Deciding between a Master-Feeder and a Side-by-Side Structure	2
ERISA Considerations	2
Issues Relating to Side Pockets	3
Use of the Media by Private Funds	3
Blue Sky in a Nutshell (and Form D).....	4
Reporting of Investment Positions	4
II. MANAGEMENT COMPANY CONSIDERATIONS.....	5
Choosing a Name	5
Drafting the Management Company’s Operating Agreement.....	5
Office Leases and Office Relocations.....	6
Drafting an Employee Handbook.....	7
Employment Agreements	7
Understanding Seed Capital Arrangements	8
SEC Investment Adviser Registration and Compliance.....	8
Commodity Exchange Act and Related National Futures Association Rules.....	10

I. Private Fund Considerations

Deciding between a Master-Feeder and a Side-by-Side Structure.

One of the fundamental decisions in structuring private investment funds for U.S. and non-U.S. investors is whether to use a master-feeder or a side-by-side structure. In a typical master-feeder structure, a U.S. limited partnership (open to U.S. taxable investors) and an offshore corporation (open to U.S. tax-exempt and non-U.S. investors) invest all of their assets in an offshore “master” entity taxable in the U.S. as a partnership. All of the trading is conducted in the master fund and the feeder vehicles participate pro rata in such trades. In a typical side-by-side structure, a U.S. limited partnership and an offshore corporation 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 “re-balancing” 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.
- 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, a master fund may have better opportunities for leverage than a stand-alone U.S. fund.

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

- The manager can manage for tax efficiency in the U.S. 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 of 1940 (the “Investment Company Act”), a total of 100 U.S. beneficial owners is permitted in a master-feeder structure, whereas in a side-by-side structure, a total of 200 U.S. beneficial owners is generally permitted (i.e., 100 U.S. taxable beneficial owners in the U.S. fund and

100 U.S. tax-exempt beneficial owners in the offshore fund).

- Generally, a 3(c)(1) fund and a 3(c)(7) fund are not combined in a single master-feeder structure, while a side-by-side structure will permit the use of both a 3(c)(1) and 3(c)(7) fund pursuing identical strategies (note that in a 3(c)(7) fund, so long as each U.S. investor can represent that it is a “qualified purchaser” (i.e., generally, \$5 million in net “investments” for individuals and \$25 million in net “investments” for entities), there can essentially be an unlimited number of investors (although a fund with 500 or more investors may be subject to registration and reporting requirements under the Securities Exchange Act of 1934)).

- A stand-alone U.S. fund may be eligible for certain tax treaties, 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 U.S. 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 manager will have to decide which structure best suits its strategy, target investors and other relevant factors. It has been our general experience that a master-feeder structure may be more appropriate when a significant portion of the investments are other than publicly-traded securities and/or portfolio turnover is very high.

ERISA Considerations. Calculating ERISA’s 25% Test.

Private investment funds and their advisers 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 investment fund and its adviser will be subject to ERISA’s fiduciary rules if investment in the 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 investment fund reaches the 25% Threshold, it may be prohibited from making certain investments and its adviser 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 investment 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 advisers. There are three primary areas of concern for funds that exceed the 25% Threshold:

(i) **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 manager, the fund's service providers, 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 a manager to pursue its investment strategy. In particular, managers often rely on the exemption for qualified professional asset managers ("QPAMs") to provide relief from ERISA's prohibited transaction provisions.

(ii) **ERISA Compliance.** The manager of a fund exceeding the 25% Threshold will also be subject to other compliance obligations, including: (a) a requirement to be covered by an ERISA "fidelity bond", (b) 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 such investor can include this information on its Form 5500, and (c) 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.

(iii) **Liability.** The manager 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 manager 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 fund for such a breach.

Issues Relating to Side Pockets. In order to access unique opportunities in the market, certain hedge funds from time to time may wish to make illiquid or restricted investments (including private equity investments) if permitted by the fund's investment strategy and governing documents. Both the timing of liquidation and the valuation of these investments may be difficult to assess. As a result, a hedge fund manager may structure a fund to enable the manager to segregate such investments from the liquid portion of the fund's portfolio into designated accounts ("Side Pockets").

An investor may not voluntarily withdraw the portion of its investment attributable to a Side Pocket and will generally be required to continue to participate in a Side Pocket in which the investor has an interest until the particular investment is liquidated or otherwise realized. Assets held in a Side Pocket will typically pay the management fee

throughout the life of the Side Pocket, but the incentive allocation generally will not be assessed until there is a realization event. While most hedge funds already have certain liquidity protections available to the fund (e.g., in-kind distributions, liquidating accounts, suspension of withdrawals and/or gates), Side Pockets may provide an additional layer of protection during certain market environments or circumstances in which a manager intends to make a suitable illiquid investment. In particular, a Side Pocket may be beneficial where a manager is concerned about managing the liquidity needs of the fund and at the same time ensuring that investors who withdraw from the fund do not cause a significant liquidity burden to investors who remain in the fund (i.e., by forcing the fund to sell liquid investments to pay withdrawal requests and retain illiquid investments for its remaining investors).

Use of the Media by Private Funds. Private investment funds such as hedge funds and private equity funds are offered and sold to investors through private placements pursuant to an exemption from registration under the Securities Act of 1933. In order for a transaction to constitute a private placement, no form of general solicitation or advertising may be used, including cold calls, public interviews, publicly accessible web sites, the use of the Internet, social or business networking websites (e.g., LinkedIn, Facebook) or use of the media, such as advertisements, press releases or articles. Moreover, although not the focus of this article, a manager generally may not use the media (or any other means) to hold itself out to the public as an investment adviser unless the manager is registered (i.e., with the U.S. Securities and Exchange Commission ("SEC") and/or a relevant state securities division, depending on the circumstances).

With the growing popularity of private investment funds as an alternative asset class, such funds have become the focus of increased media attention. Many articles on various funds and their strategies are being published. Fund managers should be aware that these articles raise potential regulatory concerns. A fund could be considered to run afoul of the private placement exemption (and could jeopardize its exemption under the Investment Company Act) if it were mentioned in such an article, especially if it cooperated voluntarily in the publication. The following are some developments in this area:

- In various releases, the SEC has expressed concern regarding the "retailization" of hedge funds. The SEC has stated that advisers are targeting investors who are not financially sophisticated enough to understand all of the risks associated with an investment in a private investment fund. The SEC has noted that some funds have lowered their minimum investment requirements.

- In the SEC’s 2003 Staff Report on Hedge Funds, the staff of the Division of Investment Management expressed concern that current marketing practices by some fund managers (e.g., the use of newsletters, the Internet, press articles and institutional reporting services) raise questions as to whether the fund is engaging in a general solicitation or advertising.

- On July 12, 2005, the SEC censured and fined two affiliated advisers for making a general solicitation of their hedge funds. The funds were advertised through radio advertisements, seminars and on the Internet and accepted initial investments of as little as \$50,000.

- Fund managers should be aware that it is common for counterparties to ask for factual representations and legal opinions relating to a fund’s private offering status. To the extent that a fund has engaged in activities that could constitute a general solicitation, the fund may be advised to impose a “cooling-off” period on the fund’s offering before it can make the factual representations or obtain an opinion.

In light of the foregoing, managers should be careful to avoid activities that could be considered a general solicitation or advertising with respect to their funds and should seek appropriate counsel prior to allowing their funds to appear in the media.

Blue Sky in a Nutshell (and Form D). A significant compliance matter for private investment funds is compliance with state “blue sky” filing laws. Essentially, a “blue sky” filing is a filing that is made with a state relating to a sale of interests (i.e., securities) in a fund, including an offshore fund, to any investor in that state. The following are some basic guidelines that should be followed:

- A Form D must be filed electronically with the SEC within 15 days after the first sale of a fund interest.

- Most states require a filing of Form D within 15 days after the first sale in such state.

- A number of states (e.g., Florida, Kentucky, Texas and Utah) have de minimis, institutional investor or other exemptions; however, before relying on any such exemption, counsel should be consulted.

- Certain states (e.g., Alaska, Georgia, Illinois, Mississippi, New Hampshire, North Dakota, South Carolina and Vermont) require that renewal filings be made after the initial filing.

- Material changes (e.g., a change of name, address or general partner) will usually require an amendment filing to be made.

- Blue sky filings are also required in connection with the acceptance of certain U.S. investors (including U.S. tax-exempt investors) in an offshore fund.

- Counsel responsible for making the fund’s filings should be notified promptly after any sale.

- Failure to make timely blue sky filings may result in various penalties, including the imposition of fines on the manager and/or the requirement that the fund make a rescission offer to affected investors.

Reporting of Investment Positions. Increasingly, investors in private investment funds have been demanding more information concerning investments held by their funds. In addition to reporting information to investors under terms previously agreed upon with them, there are a number of regulatory reporting requirements with which funds and/or managers are already obligated to comply, including the following:

Securities Exchange Act of 1934 (the “Exchange Act”). A Schedule 13G filing with the SEC, the issuer and the applicable exchange is generally required if a passive investment position of greater than 5% (but less than 20%) of the outstanding securities of a class of publicly-traded “equity” security registered under the Exchange Act is beneficially owned. Beneficial ownership is determined by looking at all accounts over which the investment manager has investment discretion. A Schedule 13D filing is generally required if (i) the position size is 20% or greater, (ii) the position size is between 5% and 20% and is not passive, or (iii) the manager or an affiliate is a director or officer of the issuer. Schedule 13D filings are required promptly after the initial trigger is met and at various other times to reflect certain changes in holdings or status. Schedule 13G filings are generally not required as frequently and do not require as extensive information as 13D filings. For registered investment advisers, the 13G/13D filing requirements are less frequent. The manager and certain of its principals (and sometimes, the fund itself) generally are the reporting persons on these schedules.

A quarterly Form 13F filing with the SEC is generally required if, at the end of any month in the prior year, the assets under management (other than personal assets) were in excess of \$100 million of long positions in public equity securities (typically, publicly-traded U.S. equities, options, warrants and certain convertible securities). An initial Form 13F filing is required on February 14 (and thereafter 45 days after each quarter-end). The SEC provides a quarterly list of the securities disclosable on Form 13F.

A Form 3, 4 or 5 filing with the SEC, the issuer and the applicable exchange is generally required by a director, officer or a greater than 10% beneficial owner of any class of a publicly-traded “equity” security or derivative security registered under the Exchange Act. Beneficial ownership is determined in the same manner as for Schedule 13D filings. Under Section 16 of the Exchange Act, “short swing

profits” may have to be disgorged to the issuer to the extent of the beneficial owner’s “pecuniary interest” with respect to purchases and sales or sales and purchases made within six months of each other. Purchases and sales may include routine transactions such as rebalancing trades and in-kind distributions. Generally, Form 3 filings are required within 10 days after the initial trigger is met, Form 4 filings are required within two business days after a transaction in the subject security to reflect certain changes in ownership status, and Form 5 filings are required annually to reflect certain other ownership changes. The manager and certain of its principals (and sometimes, the fund) are reporting persons on these forms.

Hart Scott Rodino Antitrust Improvements Act. A filing with both the Federal Trade Commission and the Department of Justice may be required for each fund prior to any acquisition that results in an aggregate position of \$63.4 million (as of June 2010) or more in the assets and/or

voting securities of an issuer being held (regardless of whether the voting securities are publicly-traded). Fees ranging from \$45,000 to \$280,000, depending on the size of the transaction, must accompany the filing. However, if a private investment fund is able to satisfy either the passive investor exemption (i.e., the acquisition is solely for investment and the acquiring person would end up holding no more than 10% of the issuer’s voting shares) or the institutional investor exemption (i.e., generally, banks, insurance companies, broker-dealers, registered investment companies and similar institutions where the acquiring institution would end up holding no more than 15% of the issuer’s voting shares, provided other specified criteria are met), it will not have to make a filing. Moreover, generally acquisitions by multiple private investment funds or accounts managed by the same manager will be treated separately and not aggregated when making the above calculations.

II. Management Company Considerations

Choosing a Name. The growth of the private investment fund industry has made the issue of selecting names for the fund and its adviser increasingly problematic. Advisers are becoming, by necessity, more expansive in their choices, given that names must often overcome potential common law, state and federal trademark, and even Internet-related, hurdles.

When selecting a company name, generally, it will first be checked for administrative availability with the secretary of state in the state of the company’s formation, as well as the state of the company’s principal office. Even if this check reveals no conflicts (with identical or substantially similar names), one must still be concerned with other conflicts.

Conflicts, for example, may exist with respect to trademarks, service marks and Internet domain names, all of which have become valuable commodities for advisers endeavoring to stand out from the crowd and avoid being confused with similarly named, but unrelated, entities. Trademarks and service marks are marks that are used, respectively, in relation to specific goods or services. An Internet domain name, if used like a trademark (i.e., as a source identifier for specific goods or services), may be a protectable trademark. A third party with relevant prior trademark rights may be able to prevent an adviser from using a particular name even if that third party has not reg-

istered its company name with the secretary of state in the same state as the adviser. Further, filing a trademark application and obtaining a trademark registration do not eliminate the prior trademark rights of third parties. Therefore, under certain conditions, third parties with relevant prior trademark rights may challenge the use of a confusingly similar name or mark by an adviser or a later-filed trademark application or trademark registration owned by the adviser.

Moreover, the geographic expansion of private investment fund advisers to areas beyond the typical financial centers has caused the formation of entities in states which, in the past, might not have been thought of as posing any conflicts. Accordingly, an entity might be formed in New York with the same name as an entity already formed in Colorado.

Essentially, while there is no foolproof methodology for eliminating name conflicts entirely, the best approach is the performance of comprehensive due diligence in all states and the trademark office, as well as common law sources such as the web (including relevant databases of the SEC, the National Futures Association (“NFA”), the Commodity Futures Trading Commission (“CFTC”) and similar organizations).

Drafting the Management Company’s Operating Agreement.

The management company of a private investment fund (i.e., the general partner of a U.S. fund or the investment manager of an offshore fund) will often take the form of a limited liability company (“LLC”) (or sometimes a limited partnership). LLCs afford their owners (called members)

limited liability like a corporation, flow-through tax treatment like a partnership and tremendous overall structuring flexibility. While some private investment fund managers start out with only one key principal and thus do not require a detailed operating agreement, when multiple members are involved (e.g., key persons are being given some form of ownership or economic interest in the business), an operating agreement addressing a number of issues should be adopted.

The operating agreement should address issues relating to governance and management, allocation of profits and losses, and withdrawals. With respect to governance and management, the agreement should cover the responsibilities of each person, how decisions are to be made, and how disputes are to be resolved. A common arrangement will vest one person, known as the managing member, with final authority. With regard to the allocation of profits and losses, the agreement may provide both for vesting provisions and for the assignment to a member of a different participating percentage for its share of each of the management fee, incentive fee/allocation and the proceeds from the sale or disposition of the business, irrespective of such member's actual pro rata capital account ownership. Oftentimes, at inception, principals will take the opportunity to establish some sort of trust for their children and make that trust a member of the LLC. Finally, with regard to withdrawals, the agreement should specify what constitutes a withdrawal (e.g., termination with or without cause, voluntary retirement or resignation, death or disability), to what degree and under what circumstances, if any, will a withdrawing member continue to participate in the profits, and whether such member will be subject to any restrictive covenants concerning non-solicitation of clients and/or employees, non-competition, and confidentiality of information.

Office Leases and Office Relocations. One of the most challenging and intimidating items facing start-up fund managers is securing office space. Office space is typically not a fund expense, but rather an expense borne by the manager (and, hence, its principals indirectly). The following is a synopsis of the principal business terms that a manager should consider when negotiating a typical lease (or sublease):

Length of Term. Most office leases have a term between three and fifteen years. Often, the tenant can obtain a right to extend the term. Given that a start-up fund has uncertain prospects, a short initial term is suggested.

Base Rent and Rent Abatement. The base rent may either stay the same for the entire lease term or change over time. Depending on market conditions, a tenant may be

able to negotiate an abatement of the base rent for a specified portion of the lease term (a “free rent” period).

Additional Rent. Many leases provide that the tenant pay, in addition to the base rent, rent attributable to operating the building in which the premises are located. In some cities, this often means that a tenant will pay its percentage share of any increases in the real estate taxes and operating expenses for the building. The tenant should make sure that the current year's expenses are used as the base year for determining such payments.

Preparing the Premises for Occupancy. If any work needs to be done to the premises, the landlord and tenant will need to negotiate who will be responsible for and bear the cost of such work. If the landlord is responsible, the parties will need to agree on precisely what work needs to be done. If the tenant is responsible, then the landlord may agree to provide the tenant with an allowance to fund the cost of such work. Note that fund managers often work with certain consultants, as well as persons at various prime brokers, who provide advice about office build-outs.

Electricity and Technology. Fund managers are often heavy users of electricity and technology. Therefore, it is important to determine whether the premises have sufficient electrical and IT wiring capacity. Most leases provide that the tenant will pay separately for electrical consumption, either on a “fixed amount” (commonly called “rent inclusion”) basis or on a “submetered” basis.

Building Services. The lease should also cover the costs and types of other services that will be provided to the tenant, including heating, ventilation and air conditioning, hours of access to the premises, cleaning, building directory listings and signage rights. Given the hours that some managers are required to operate, it is imperative that these points be considered.

Security/Guaranty. Almost every tenant will be required to provide a security deposit (either cash or, more often, a letter of credit), but the amount of the security deposit will depend on the credit risk that the landlord is willing to assume. A start-up tenant may be required to provide a relatively large security deposit. In such a case, the landlord may agree to reductions in the security deposit after a certain number of years have elapsed, provided that the tenant has not defaulted under the lease and, in some cases, has met certain other conditions.

More importantly, the landlord may also require that the principals of the tenant execute a personal guarantee of the tenant's lease obligations. If a guarantee is requested, it is strongly recommended that it be a “good guy” guarantee, which essentially means that the guarantor's liability ends once the tenant vacates the premises, although the ten-

ant itself may continue to remain liable under the lease following the surrender of the premises.

If a manager is relocating its principal office, it should consider the following issues:

- *Operational Issues.* A manager may want to hire a space consultant and/or architect to design a plan that maximizes the efficiency of the available space.

- *Financial Issues.* Typical expenses may include the cost of business interruption, moving and the purchase of new furniture, office and technological equipment, as well as increases in rent, utility and HVAC charges, security services and technological services.

- *Documentation Issues.* Fund and management company operating and other documents (e.g., insurance plans, tax forms, payroll and stationery) will need to be updated upon the firm's relocation.

- *Notification Issues.* The manager should promptly send a letter to its clients, counterparties and other relationships that informs them of the impending move.

- *Legal/Regulatory Issues.* A manager will need to determine whether the move will: have potential tax consequences; require any company restructuring; trigger any investment adviser registration requirements; and/or require amendments to its blue sky or other securities filings.

In sum, managers should seek appropriate guidance prior to securing office space.

Drafting an Employee Handbook. As fund management companies grow and more employees are hired, communication of company policies and procedures, as well as compliance with legal posting and notice obligations, becomes increasingly difficult. Once a company reaches this point, an employer should consider adopting an employee handbook that clearly explains its employment policies. A careful employer should take the time to tailor the handbook to meet its specific concerns and should review it periodically to ensure that it is current in light of new developments.

Topics addressed in an employee handbook may vary from company to company depending on size, organizational needs and state law. Most handbooks begin with an introduction, which typically provides a brief history and business philosophy of the company and sets a tone for the remainder of the handbook. Employers often find that the handbook is also an ideal place to provide what is expected of employees in terms of work hours, attendance, use of drugs and alcohol, standards of behavior and appropriate dress, as well as what benefits employees can expect to receive from the company, such as sick time, vacation time, holidays, personal days, paid leave, and group insurance and retirement plans. Other typical policies include those involving non-discrimination and anti-harassment, commu-

nications and technology systems, confidential information, travel and business expenses, and paydays. Setting out policies in handbooks may also satisfy certain state legal notice requirements, including those relating to smoking, drug testing or access to employee records.

Advantages to maintaining an employee handbook are numerous. If drafted, distributed and acknowledged properly, a handbook can be a practical tool to help manage a company. It limits disagreements as to whether an employer communicated certain policies to its employees and helps ensure that the policies are communicated consistently. It also reduces employee anxiety about job requirements and the correct procedures to follow if and when certain events occur, such as illness, pregnancy, emergencies, snow days or an uncomfortable situation, such as harassment.

Employment Agreements. An employment agreement, when properly drafted, can go a long way towards minimizing potential pitfalls in the employment relationship. In the investment management business, where compensation arrangements can be complex and the need to protect confidential and proprietary information is paramount, an employment agreement that clearly sets forth the business terms can prove to be a very valuable management tool.

A well-drafted employment agreement will contain protections for the employer both during and after the employment relationship. Among other things, the agreement should clearly state the following: (i) the terms of the relationship; (ii) the employee's compensation; (iii) protections for the employer's confidential information; (iv) protections against former employees "poaching" current employees and competing with the firm; (v) protections against soliciting clients away from the employer; and (vi) any notice period or "garden leave" period.

Additionally, an anxious applicant may be tempted to omit information or not be entirely truthful with a prospective employer. An employment agreement that requires the prospective employee to make certain representations regarding his or her past employment and future conduct can help protect the employer in the event an untruth or an omission is discovered down the road.

Finally, while a well drafted employment agreement can be a source of protection to an employer on a variety of issues, employers must be cautioned that "cookie cutter" or template agreements can do more harm than good. For instance, the failure to clearly set forth compensation terms and any contingencies to the payment of such compensation can lead to time-consuming and costly disputes resulting from the employee's expectations not having been properly managed. Although it may be true that many elements may be unchanged from agreement to agreement, each employment

situation is different and employment counsel should be consulted before entering into any agreement with an employee.

Understanding Seed Capital Arrangements. The benefits that a seed investor's capital and other services offer a start-up fund manager may be significant. Even seasoned managers may sometimes opt for such arrangements to launch a new fund, increase their size or visibility, or gain access to the seed investor's input.

Most managers will view seed capital as a seed investor's greatest contribution to the success of a start-up fund. A substantial initial investment not only generates fees, but may also provide the legitimacy necessary to attract additional investors and the critical mass needed to implement certain trading strategies. In addition to seed capital, some seed investors may also offer access to a broader investor base as well as administrative, accounting and other support services.

While the value of these contributions to a fund's success can be substantial, a manager needs to understand fully how these alliances work. The typical seed capital arrangement, which may be perpetual or last for as long as ten years, is negotiated on a case-by-case basis and will usually grant the seed investor a share in the fees through equity ownership in the manager or a long-term contractual arrangement. Set forth below is a synopsis of the most important considerations from the manager's perspective:

- **Fee Sharing Structure.** While fee sharing structures may vary significantly, a manager can expect that anywhere from 10 to 50 percent of its fees will be allocated to the seed investor on an annual basis. The fee sharing arrangement may be based on total assets under management or may be limited to certain contributions. It may fluctuate during the term of the arrangement depending upon elapsed time, assets raised and/or performance results. The terms of the arrangement may also prevent the manager from entering into negotiated arrangements with other fund investors.

- **Size and Timing of Commitment.** While a seed investor's capital commitment may be significant, receipt of the full amount, whether in a lump sum or in several tranches, may be conditioned on certain events such as the fund meeting asset benchmarks or achieving specified returns. In addition, the seed capital may be committed for a limited term rather than the term of the fund. While a manager should expect to receive a commitment of two to three years, the investor may be permitted to withdraw any appreciation on its initial investment, or sometimes its principal investment amount, if certain conditions exist, including fund performance falling below specified targets, the aggregate amount of capital in the fund exceeding specified thresholds prior to the end of the commitment period or the

manager's principals ceasing to be actively involved in management.

- **Buy-Out Provision.** A manager may want the option to repurchase all or part of the seed investor's interest based on a formula price, an appraisal or some other arrangement. Alternatively, the seed investor may request "put" rights, requiring the manager to purchase its interest under certain conditions, such as the sale of the manager, a performance drawdown, the departure of key talent or simply on the demand of the seed investor. Typically, these buyouts will be based on a multiple of fees earned over a certain time frame.

- **Capacity.** Seed investors will often require the manager to reserve for it a specific amount of the fund's capacity, thus preventing the manager from diluting the seed investor's future position and influence in the fund.

- **Non-Competition.** Seed investors may seek to prohibit the manager's principals from utilizing similar strategies for other accounts for the term of the commitment or arrangement, and often for one to two years thereafter.

- **Tax Issues.** The economic arrangements between the manager and a seed investor could be significantly impacted by a number of tax issues including: (i) the nature of the manager's revenues to be shared with the seed investor (e.g., management fees, incentive fees and allocations, and/or proceeds from the sale of the manager's business); (ii) whether the seed investor is a tax-exempt entity or a non-U.S. person or entity or is a heavily regulated entity; and (iii) whether the arrangement relates to both a domestic and an offshore fund (and the classification of those entities for federal income tax purposes).

SEC Investment Adviser Registration and Compliance. For managers required to register as investment advisers with the SEC, set forth below is a discussion of the principal registration and compliance requirements for advisers registered with the SEC (state requirements may differ).

(1) **Registration Requirements:** Generally, in order to become an investment adviser registered with the SEC, a manager must file Part I of the Form ADV and, starting in 2011, Part 2A of the Form ADV with the SEC.

- **Part I of Form ADV.** An adviser seeking to register must file Part I of Form ADV electronically through the SEC's Investment Adviser Registration Depository. Part I, which is mainly in a check-the-box format, discloses background and other basic information about the adviser such as control persons, disciplinary history and assets under management. The SEC has 45 days after receipt of Part I to declare an adviser's registration effective. There is no examination requirement as part of the Form ADV filing. Filing fees, which are relatively insignificant, are assessed for both the initial filing and for each annual

amendment, based on assets under management and the number of state notice filings. A registered adviser is required to amend Part I its Form ADV each year by filing an annual updating amendment within 90 days of the end of its fiscal year, with more frequent updates required for certain material changes.

- *Part 2 of Form ADV.* The SEC adopted significant amendments (“Amendments”) to Form ADV Part II (now called “Form ADV Part 2”), effective October 12, 2010, that require registered advisers, beginning in 2011, to comply with new format, content, delivery and filing requirements. Form ADV Part 2, which must now be drafted in narrative form, is divided into two main components: Part 2A, which is known as the “Firm Brochure,” and Part 2B, which is known as the “Brochure Supplement”. The Firm Brochure is meant to provide advisory clients with more enhanced disclosure than previously required by the old ADV Part II, including disclosure related to an adviser’s performance-based fee arrangements, methods of analysis, investment strategies and related conflicts, among other items. Meanwhile, the Brochure Supplement is meant to provide advisory clients with more detailed information with respect to each “supervised person” who either formulates investment advice for a client and has direct client contact or who makes discretionary investment decisions for client assets. In particular, the Brochure Supplement will contain greater disclosure regarding the education, disciplinary history, other business activities and compensation arrangements, among other items, of such supervised persons.

The Amendments require advisers to electronically file with the SEC on an annual basis the Firm Brochure and a summary of material changes; however, there is no requirement to file the Brochure Supplement with the SEC. Further, advisers must now deliver to clients on an annual basis the Firm Brochure (with the summary of material changes), or alternatively, the summary with an offer to provide the current Firm Brochure at no charge, along with other requirements. While advisers must deliver the applicable Brochure Supplements to the appropriate clients at or before the time advisory services are provided to such clients, advisers have no annual delivery obligation to their clients with respect to the Brochure Supplement. More frequent amendments (and corresponding delivery) of the Firm Brochure and the Brochure Supplement may be necessary for certain material changes.

(2) *Compliance Requirements:* Once an adviser is registered with the SEC, it will be subject to numerous ongoing compliance obligations (which may be checked via surprise periodic SEC examinations of the adviser), including:

- *Compliance Program.* A registered adviser is re-

quired to (i) adopt and implement compliance procedures; (ii) annually review such procedures; and (iii) designate a chief compliance officer. Compliance procedures should address, among other areas of operations: portfolio management processes; trading and brokerage practices; proprietary trading and personal trading; disclosures to clients; custody of client assets; recordkeeping; marketing of services; insider trading; proxy voting; client information safeguards; valuation; political contributions and business continuity planning. The chief compliance officer should be knowledgeable regarding the Investment Advisers Act of 1940 and empowered with full responsibility and authority to develop and enforce the compliance procedures. Advisers may designate a principal or existing employee to serve as chief compliance officer, provided that such person is qualified.

- *Code of Ethics.* A registered adviser is also required to adopt a code of ethics to prevent fraud by firm personnel, with minimum provisions to address: standards of business conduct; compliance with federal securities laws; personal securities reporting; pre-approval of certain transactions and reporting of code of ethics violations.

- *Recordkeeping.* Registered advisers are required to make, maintain and preserve certain books and records concerning client accounts, including any required records that may be in e-mail form. These records are subject to SEC inspection. Generally, these books and records must be kept in an easily accessible place for at least five years and may, subject to certain requirements, be maintained electronically.

- *Custody.* Registered advisers (or related persons) who hold, directly or indirectly, client assets or who have the authority to obtain possession of them must, subject to certain exceptions: (i) maintain client assets with a “qualified custodian”; (ii) arrange for account statements to be sent to clients at least quarterly by the custodian; (iii) undergo an annual surprise examination by an independent public accountant; and (iv) if the adviser (or related person) serves as the “qualified custodian”, obtain a written internal control report from an independent public accountant stating that the adviser has established appropriate custodial controls. Note that many advisers to private funds avail themselves of an exception to the account statement delivery requirement in (ii), and are deemed to satisfy the surprise examination requirement in (iii), by undergoing an annual audit and delivering audited financial statements to clients within 120 days of the end of the private fund’s fiscal year (180 days for a fund of funds).

- *Performance-Based Fees.* Registered advisers are generally prohibited from charging fees based on the appre-

ciation of a client's assets, unless the arrangement complies with SEC rules. The most common permitted arrangement is that an adviser can charge a performance-based fee, if the client (or investor in a private fund that charges performance compensation) is a "qualified client" (a person that has a net worth exceeding \$1.5 million or at least \$750,000 under the adviser's management) or a "qualified purchaser" (as defined in the Investment Company Act). It is possible that the "qualified client" standard will increase in the next year, since the Dodd-Frank Wall Street Reform and Consumer Protection Act has directed the SEC to adjust the "qualified client" standard for inflation within one year of its enactment on July 21, 2010 (and every five years thereafter).

- *Advertising and Performance Reporting.* Registered advisers are subject to numerous SEC interpretations relating to marketing their services and the disclosure of their performance.

Commodity Exchange Act and Related National Futures Association Rules. If a private investment fund trades any type of futures contract (including single stock futures), even if only for hedging purposes or on a de minimis basis, CFTC registration of the fund's manager as a commodity pool operator may be required, unless registration relief is available. The CFTC registration requirement would also apply to the manager of (i) an offshore fund with a U.S. jurisdictional nexus (such as those funds with a U.S. manager, U.S. director(s) and/or U.S. investors), or (ii) a fund-of-funds that invests in other funds that trade futures. Among other things, CFTC registration usually requires that certain management personnel pass the Series 3 exam.

CFTC registration imposes various reporting, record-keeping and disclosure obligations. These obligations may be minimized if the manager can rely on the exemptions in

CFTC Rules 4.7 or 4.12(b). Rule 4.7 requires investors to be "qualified eligible persons," generally defined as persons who are both accredited investors and have specified dollar amounts of certain investments. Rule 4.12(b) is available if the fund meets certain criteria, including that its trading in commodities is "solely incidental" to its securities trading and that no more than 10% of its assets are committed as initial margins and premiums on commodity futures and commodity options contracts.

Alternatively, a manager may seek total relief from registration as a commodity pool operator under CFTC Rules 4.13(a)(3) or 4.13(a)(4). Under Rule 4.13(a)(3), the fund's investors must all be accredited investors, non-U.S. persons and/or certain family trusts, and the fund must meet one of the following trading limitations at all times: (1) the aggregate initial margin and premiums required to establish commodity positions will not exceed 5% of the fund's net assets, or (2) the aggregate net notional value of such positions will not exceed 100% of the fund's net assets. Under Rule 4.13(a)(4), each fund investor that is a natural person must be a "qualified purchaser" (generally, owning a securities portfolio of at least \$5 million) or a non-U.S. person, and each fund investor that is a non-natural person must be a "qualified eligible person" (generally, owning a securities portfolio of at least \$2 million), an "accredited investor" (generally, having assets in excess of \$5 million) or a non-U.S. person or entity. There is no trading limitation under this exemption. Managers who file an exemption under 4.13(a)(3) or 4.13(a)(4) are required to keep all books and records prepared in connection with their activities as a pool operator for at least five years, and such books and records must be kept "readily accessible" for the first two years of the five year period.

Seward & Kissel LLP provides legal advice to its investment management clients on structure, business planning, regulatory, compliance, corporate finance, asset securitization, capital markets, business transactions, derivatives, bankruptcy/ distressed debt, tax, ERISA, litigation, trademark, employment, trusts & estates and real estate matters.

Publications. Prior editions of the Private Funds Report and an Index to Covered Topics may be found on the web at www.sewkis.com under Publications.

Attorney Advertising. Prior results do not guarantee a similar outcome. The information contained in this newsletter is for informational purposes only and is not intended and should not be considered to be legal advice on any subject matter. As such, recipients of this newsletter, whether clients or otherwise, should not act or refrain from acting on the basis of any information included in this newsletter without seeking appropriate legal or other professional advice. This information is presented without any warranty or representation as to its accuracy or completeness, or whether it reflects the most current legal developments. Seward & Kissel LLP disclaims any and all liability to any person for any loss or damage caused by any actions taken or not taken based on any or all of the information in this newsletter.

Partners and Counsel from Other Groups Actively Involved with the Private Investment Fund Practice

Tax/ERISA/Trust & Estates

Ronald P. Cima	(Tax)
James C. Cofer	(Tax)
Daniel C. Murphy	(Tax)
Peter E. Pront	(Tax)
S. John Ryan	(ERISA)
Hume S. Steyer	(Trusts & Estates)
David E. Stutzman	(Trusts & Estates)

Bankruptcy

John R. Ashmead
Ronald L. Cohen
Arlene R. Alves

Corporate Finance

Craig Hickernell	(Derivatives, Counterparty Agreements)
Lauri K. Goodwyn	(Derivatives, Counterparty Agreements)
Greg B. Cioffi	(Distressed Debt)
Renee Eubanks	(Distressed Debt, Asset Securitization)
James H. Hancock	(Corporate Finance, Asset Securitization)
Lawrence Rutkowski	(Corporate Finance)
Edward S. Horton	(Capital Markets)
Robert E. Lustrin	(Capital Markets)
Gary J. Wolfe	(Capital Markets)
James E. Abbott	(Business Transactions)
Craig A. Sklar	(Business Transactions)

Real Estate

Mark A. Brody
Robert J. Gorzelany
Adam D. Lesnick

Litigation/Securities/ Employment

Mark J. Hyland	
M. William Munno	
Anne C. Patin	
Jack Yoskowitz	
Beth H. Alter	(IP, Trademarks)

SEWARD & KISSEL LLP

If you have any questions or comments about this newsletter, please feel free to contact any of the attorneys in our Investment Management Group specializing in private investment funds via telephone at (212) 574-1200 or e-mail generally by typing in the attorney's last name @sewkis.com

INVESTMENT MANAGEMENT GROUP

Partners

John J. Cleary
Maureen R. Hurley
Paul M. Miller
Steven B. Nadel
Anthony C.J. Nuland
Patricia A. Poglinco
Christopher C. Riccardi
Jack Rigney
John E. Tavss
Robert B. Van Grover

Counsel

Robert L. Chender
Kathleen K. Clarke
Anthony Tu-Sekine
Bibb S. Strench



SEWARD & KISSEL LLP

One Battery Park Plaza, New York, New York 10004

Telephone: (212) 574-1200 **Fax:** (212) 480-8421 **Email:** sknyc@sewkis.com

www.sewkis.com

©2010-2011 SEWARD & KISSEL LLP — All rights reserved. Printed in the USA.