Chapter 47

Private Equity Funds:
Legal Analysis of Structural,
ERISA, Securities and Other
Regulatory Issues

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§ 47:1 Introduction

§ 47:1.1 What Is a Private Equity Fund?

The term “private equity fund” is commonly used to describe a broad range of actively managed pooled investment vehicles, investments of which primarily consist of non-publicly traded securities and that have a finite duration (typically ten years with the ability to extend the term for two or three consecutive one-year periods). Private equity funds are typically organized as limited partnerships where sophisticated and institutional investors make a capital commitment to fund investments over the duration of the fund. Although private equity funds have a variety of investment strategies, they tend to be loosely categorized into venture capital funds and buyout funds. Venture capital funds have historically sought minority stakes in relatively young or start-up private companies and provide both equity capital and management skills. It is common for a venture capital fund to require as a condition to its investment that it receive seats on the board of directors of a portfolio company, which are useful both for providing management expertise and for monitoring the investment. Venture capital funds have historically sought liquidity for their portfolio investments through the public markets. Buyout funds, on the other hand, have traditionally sought control positions [through majority ownership and board representation] in mature underperforming or undervalued companies. Buyout funds have typically sought to leverage their equity investment with debt financing, and accordingly are more concerned with the ability of a company to generate stable cash flows (which can be used to service the debt) than are venture capital funds.

Notwithstanding the variety of strategies employed by private equity funds and the different focus of venture capital funds and buyout funds, many of the issues that arise during the formation, ongoing operation and investment of such funds are similar.
§ 47:2 A Typical Private Equity Fund

§ 47:2.1 Fund Structure

At its most basic level, a private equity fund is a pool of money that is invested in the unregistered securities of public or private companies. The fund is managed by a team of skilled investment professionals who identify investment opportunities, execute transactions, provide management and other expertise, and monitor portfolio investments. Successfully structuring a fund from a legal perspective requires a consideration of state and federal regulations, including securities law issues, tax, liability, ERISA, and other issues. Generally, funds have addressed these issues through variations on a limited partnership model, in which the investors hold limited partner interests and the management team holds an interest in an entity that serves as the general partner. Generally, the management team or sponsor will organize a separate management company in addition to the general partner entity, which will contract with the fund to provide management and advisory services. The aim of the fund limited partnership model is to eliminate entity-level tax while protecting the investors in the fund from personal liability for the debts and obligations of the fund. While this model is most typically implemented through a limited partnership, many of the same benefits can be achieved through a limited liability company (LLC) in jurisdictions where the LLC form is recognized. If the fund is to make investments outside the United States, a fund organized as an LLC may not be optimal for tax purposes.

In order to take advantage of the private placement rules under the U.S. securities laws, private equity funds typically limit their offering to sophisticated investors, including public and corporate employee benefit plans, insurance companies, bank holding companies, university endowments, sovereign wealth funds, and family offices or high net worth individuals who have sufficient market experience to evaluate an investment in the fund. The investors may themselves hold their limited partner interests in the fund through a corporation, a partnership, an estate planning vehicle, an LLC, or directly. As in the case of choosing the organizational form for the fund as a whole, an investor will structure his, her, or its investment in the fund based primarily on tax and liability considerations. Foreign and tax-exempt investors will have additional considerations to take into account in deciding how to hold an interest in a fund.

§ 47:2.2 Management of the Fund

Private equity funds are managed by a management company organized by the sponsor that may act as the general partner of the fund or through a management contract with the general partner and
the fund. The management company will play an active role in raising investment capital, locating investment opportunities, executing investment transactions, providing leadership or management advice to the portfolio companies, monitoring the investments, and achieving liquidity for the fund’s investments. For these services, the management company is typically paid a management fee. The fee is paid in an annualized amount typically between 1% and 2% of the fund’s aggregate capital commitments over the life of the fund.\(^1\) Buyout funds typically structure the management fee to step down or phase out over a given period of time. In one commonly used formula, the full percentage fee is paid based on total committed capital for a specific number of years (typically the initial five- or six-year period during which most of the commitments are invested, known as the “investment period,” or until a successor fund is raised) followed by a lower management fee based on the amount of invested capital still held by the fund thereafter. Venture capital funds are less likely than buyout funds to have management fees step down or phase out over a given period of time or do so on a slower basis, in part because venture capital funds generally manage smaller pools of assets than buyout funds. Venture capital funds may also use scale-ups during the early years of the fund to balance a slower step-down in the predecessor fund.\(^2\)

The management company and general partner will generally be organized as limited partnerships or LLCs. The preferred form, as discussed in infra section 47:3 with respect to the fund, is a pass-through entity for tax purposes. An LLC structure for a management company or general partner provides its members (both managing and non-managing) with both protection from unlimited liability and pass-through tax benefits.\(^3\) However, as some foreign jurisdictions do not recognize U.S. LLCs as pass-through entities for tax purposes, a management company or general partner with non-U.S. management personnel may find an LLC structure disadvantageous and may use a limited partnership instead.

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1. One study indicated that the median starting annual management fees for buyout funds were 2% of committed capital, with the majority of the private equity funds surveyed charging 2% and below. See Dow Jones, Private Equity Partnership Terms and Conditions [2011 ed.] [hereinafter Partnership Terms], at 29 and exh. 2.3. In addition to annual management fees, many private equity firms received income from fees for services charged to their portfolio companies (e.g., investment banking or consulting services). Frequently, the management company and investors agree to offset the investors’ annual management fee obligation with all or a portion of such fees received by the management company or its affiliates.

2. Partnership Terms, supra note 1, indicate that the median starting annual management fees for venture capital funds were 2.5% of committed capital. See id. at 29–30 and exhs. 2.3 and 2.4.

3. See infra section 47:3.2.
The sponsors of a fund will themselves typically make a significant equity investment in the fund in order to align the general partner’s interests with those of the limited partners.

In addition to managing the fund, the investment professionals at the management company will take an active role in monitoring and advising the portfolio companies. As a result, these persons must be knowledgeable not only about finance and investing but also more generally about the successful operation of a business. The types of investments that the fund makes will dictate the expertise needed. Venture capital funds typically invest in young or start-up businesses with potential for strong growth. Accordingly, venture capital fund managers need management skills necessary to develop a new business. By contrast, buyout funds invest in mature or underperforming or undervalued companies. As such, managers of a buyout fund require a set of skills necessary to revitalize, redirect, refinance or manage a mature company, to restore or develop business confidence and direction, and to handle bankruptcy issues. To maximize this expertise, many venture funds concentrate on an industry or segment, for example, biotechnology or software. Similarly, many buyout funds concentrate by industry or geographical sector and/or by size of investment.

§ 47:2.3 Allocation of Profits

There are many ways in which profits and losses may be divided among investors and managers of a private equity fund. The allocation scheme specified in fund documents will be market-driven and will depend on the nature of the investors, the capabilities and expertise of management, the type of fund, and the specific investments the fund expects to make. By far the most common allocation is a 20% profit allocation or “carried interest” to the general partner, with the remaining 80% of profits allocated among the partners according to contributed capital (including contributions by the general partner). For example, consider the following simple fund: $100 total investment with $95 contributed by investors and $5 contributed by the general partner. Assuming the fund doubles in value to $200 over the life of the fund, the general partner receives a total of $24: $20 (20% × $100 profit) as carried interest and $4 as its share of profits according to contributed capital (5% × $80 remaining profit). The general partner’s return would be $24 on its $5 cash investment, plus the return of its $5 investment (5% × $100 investment). The other investors would receive $76 (95% × $80 remaining profit) as a return on their $95 of contributed capital, plus the return of their $95 investment (95% × $100 investment). 4

4. This simple example excludes any consideration of the management fee paid to the general partner or management company.
Returns of capital contributions and distributions of profits are made from private equity funds as and when proceeds are realized from the investments made by the fund. In buyout funds, the general partner often does not participate in any profit sharing until a certain minimum return or hurdle rate has been achieved, generally referred to as a preferred or priority return. Under a preferred return allocation, 100% of profits are first allocated to the investors according to contributed capital until the fund reaches a specified rate of return, and then any remaining profits are allocated to the general partner and the limited partners according to a specified formula. For allocations of amounts in excess of the hurdle, there are two primary formulae used by the industry. The first, and more popular, allocation scheme returns 100% of profits exceeding the hurdle to the general partner as carried interest until the general partner receives a full 20% earned interest on all profits (the equivalent carried interest to the 80-20 allocation scheme), and then any remaining profits are allocated as carried interest to the general partner and 80% of profits are allocated according to contributed capital. This type of allocation scheme is known as a “disappearing preferred return” because the initial preferred return of a specified hurdle to the investors disappears as profits in excess of the hurdle are allocated 100% to the general partner until they reach the standard 20% carried interest. The second, and less common, technique is to allocate profits in excess of the hurdle as 20% carried interest to the general partner and 80% to the limited partners according to contributed capital. This profit allocation is known as a “permanent preferred return” because the general partner is not permitted to catch up with respect to the hurdle distributions.

Typically, the general partner is required to agree that if, over the life of the fund, it receives carried interest distributions in excess of the intended allocation, it will return the excess distributions generally on an after-tax basis. These types of provisions are commonly referred to as a general partner “clawback.” Because the general partner entity is often a special purpose entity formed to serve as general partner of a particular fund with no assets other than its interest in the fund, limited partners may be concerned that the general partner will not have sufficient assets to fulfill its clawback obligation, especially if the general partner has, in turn, distributed the carry to its partners or

5. In fact, one study indicated that 91% of the buyout funds studied had a preferred return. See PARTNERSHIP TERMS, supra note 1, at 40 and exh. 3.7. In contrast, only 41% of the venture capital funds surveyed had a preferred return. Id.

6. The rate of general partner catch-up may vary, e.g., 80% (or 50%) of profits exceeding the hurdle may be allocated to the general partner until the general partner reaches a total of 20% carried interest on all profits.
members. The constitutive agreement of the general partner generally obligates its partners or members to return such distributions in the event of a clawback and limited partners often require that the members of the general partner personally guarantee the clawback payment (though this is generally on a several, rather than a joint and several, basis). Fund partnership agreements may also include provisions for escrowing a certain portion of the carried interest distributions or for an interim clawback, annual true-up or similar mechanism in order to reduce the risk that a large clawback will be required on liquidation of the fund.

§ 47:2.4 Other Common Provisions

A number of other provisions are typically found in private equity fund agreements. These provisions include the ability of the manager to require funding of any permitted investment relatively quickly upon demand (typically upon ten business days’ notice), a fixed time for the investment period (typically five to six years), limits on the ability of the manager to re-use capital previously invested and returned (commonly called “recycling”), appointment of a limited partner advisory committee to oversee potential conflict transactions, significant restrictions on investors’ ability to withdraw from the fund, requirements as to periodic reports to investors, and provisions relating to co-investment, as well as specific, very limited instances (usually based on legal or regulatory restrictions) in which investors may be excluded from or opt out of certain investments. Private equity fund limited partner interests are not liquid investments. Investors in private equity funds are generally prohibited from transferring their interest in the fund without the consent of the general partner, and investors generally have no redemption rights. Moreover, most private equity fund agreements provide that any limited partner that fails to contribute any portion of its committed capital when due may face severe adverse consequences, including the forfeiture of its interest.

While the limited partners will ordinarily give the general partner broad authority to make investment decisions (they are, after all, investing to gain the benefit of the sponsor’s expertise), the partnership’s general investment strategy is usually set forth in the partnership agreement in broad terms (for example, for a buyout fund, to achieve long-term capital appreciation through investments providing control or an influential minority position). There may also be limitations on the geographical scope of the investments, the industries targeted or the general size of the investments, depending on the focus of the fund. Increasingly, limited partners are requesting consideration of social and environmental issues and have adopted their own investment policies regarding, for example, investments in tobacco companies or defense contractors, or in certain countries
subject to sanctions (for example, Sudan). Fund agreements also typically include limits on how much capital can be invested in any single company in order to diversify the risks of investment. There may also be limitations on borrowing or investing in derivatives, which are typically associated with hedge fund investing, and investments in other pooled investment vehicles. In order to maintain flexibility in structuring transactions and to address the needs of different types of investors, particularly tax-exempt and foreign investors, fund agreements may permit the sponsor to create special vehicles through which some or all of the investors in a fund will participate in a particular investment or to create parallel funds for certain classes of investors (for example, foreign investors) or other co-investment arrangements.

The terms of any particular private equity fund will depend, first of all, on the investment strategy of the sponsor and the sponsor’s assessment of the market conditions for private equity fundraising. Depending on those market conditions, there will be a greater or lesser degree of negotiation with prospective investors. Historically, the setting for those negotiations was generally one-on-one discussions with the investors. In 2009, the Institutional Limited Partners Association (the ILPA), a trade organization whose members include some of the largest institutional investors in private equity, released its Private Equity Principles, updated in 2011 (the “ILPA Principles”). The ILPA Principles contain a set of recommendations by these institutional investors for best practices on fund terms and governance, and the ILPA Principles have become part of the dialogue between sponsors and investors.

§ 47:3 Form of the Private Equity Fund (Tax and Liability Issues)

The choice of the organizational form for the investment entity is a vital first step in the formation of a successful private equity fund. While a fund could be structured as a corporation, partnership or LLC, corporations typically are not used because partnerships and LLCs provide a significant tax advantage by avoiding entity-level taxation.

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7. Recently, the Private Equity Council, an industry group working with certain large institutional investors, has developed Guidelines for Responsible Investment, available at www.privateequitycouncil.org, encouraging its members to consider environmental, public health, safety and social issues associated with target portfolio companies.

§ 47:3.1  Partnership

Most funds are organized as partnerships because of the tax benefits associated with pass-through entities. Furthermore, the only significant benefit of the corporate form, limited liability for the fund’s equity owners, is achievable to a significant extent through the use of a limited partnership with a general partner that is itself organized as a limited partnership or a limited liability entity.

[A]  Tax Considerations of the Partnership Form

[A][1]  No Federal Income Tax at the Fund Level

The primary benefit of the partnership form is that there is no federal income tax at the entity level; that is, the fund as an entity pays no federal income taxes on capital gains or other income.9 A partnership generally is treated for tax purposes as a pass-through entity, which means that the general partner and the limited partners will be allocated shares of the fund’s items of income, gain, loss, expense, and credit for reporting on their own income tax returns based upon the characterization of the items at the fund level (as, for example, ordinary income or capital gain).10 If the fund is organized as a partnership, gains

9. This rule of no entity-level tax is applicable at the federal level and in most states and localities as well. However, a few state and local jurisdictions do impose an entity-level tax on partnerships and LLCs. See supra note 4.

10. The default federal tax classification of a domestic unincorporated organization [e.g., a partnership or an LLC] with two or more members that is not a trust or a per se corporation is as a partnership. Treas. Reg. § 301.7701-3[b](1). However, if the fund is treated as “publicly traded,” it will be taxed as a corporation. I.R.C. § 7704. Generally, a private equity fund is treated as a publicly traded partnership if its interests are either traded on an “established securities market” or are readily tradable on a “secondary market or the substantial equivalent thereof.” I.R.C. § 7704[b]. There are, however, several exceptions to publicly traded partnership treatment. First, the Internal Revenue Code contains a safe harbor for entities that earn “qualifying income,” which generally includes most categories of interest, dividends and capital gains. I.R.C. § 7704[c]. In addition, a fund generally will not be treated as a publicly traded partnership if the issuance of its interests is exempt from registration under the Securities Act of 1933 and the fund has fewer than 100 members. Treas. Reg. § 1.7704-1[b][1]. Second, the regulations provide several safe harbors for transfers that will be disregarded for purposes of determining whether a fund should be treated as a “publicly traded partnership.” See Treas. Reg. § 1.7704-1[e]. In addition, a fund will not be treated as a publicly traded partnership for a taxable year if, during that taxable year, not more than 2% of the total capital or profits interests in the fund [other than transfers of interests that fall within a safe harbor] are transferred. Treas.
from the sale of the fund’s portfolio investments are taxed only once and, if the fund’s partners are individuals and the portfolio investment has been held for more than one year, at preferential long-term capital gain tax rates. If, on the other hand, the fund had been organized as a corporation rather than as a partnership (or treated as a corporation for tax purposes), the gains would be taxed twice. For example, upon the realization of a portfolio investment, the fund, if organized as a corporation, would pay federal income taxes on capital gains at the applicable corporate tax rate, followed by taxation at the shareholder level upon the distribution of the net gains as a dividend.\(^\text{11}\)

**[A][2] Tax Considerations for Tax-Exempt Organizations**

A further benefit to a private equity fund of using the partnership form is that there are no federal income taxes at the limited partner level if the equity owner is a tax-exempt organization (and thus the tax-exempt investor generally suffers no direct or indirect tax cost as a result of investing in the fund). This tax-exempt status applies equally to ordinary income and capital gains. However, this favorable tax treatment is only available under two circumstances.

First, the investments producing the gains in question must not be treated as debt-financed by the tax-exempt investor.\(^\text{12}\) To the extent that the purchase price of an investment is financed through money

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\(^{11}\) A brief back-of-the-envelope example shows the initial tax savings of the partnership form. (Assume a corporate tax rate of 35%, dividends from the fund qualify for the reduced 15% rate, and a long-term capital gains tax rate of 15%.) A corporate fund that earns $100 in capital appreciation on an investment would pay $35 in corporate federal income tax, leaving $65 to distribute to shareholders. If the corporation distributes the $65 to shareholders as a dividend, the individual equity owner must pay $9.75 in tax. The result is a $55.25 net gain for the shareholders. However, if the fund is organized as a partnership or an LLC, capital appreciation is passed directly through to the limited partner who includes the fund’s profits and losses on its own tax return. Because the gains are capital gains, the limited partner pays $15 in tax, leaving an $85 net gain, rather than a $55.25 net gain. This is more than one and one-half times the net profit of the corporate fund with the same capital gain.

\(^{12}\) I.R.C. § 512(b)(4).
borrowed either directly by the tax-exempt investor itself, or by a fund organized as a partnership (and not a corporate subsidiary of the fund) of which the tax-exempt entity is a partner, a portion of the gain will be treated as “debt-financed income” and therefore as unrelated business taxable income (UBTI) and therefore subject to federal income tax.\textsuperscript{13}

Second, neither the fund nor any operating partnership in which the fund is an equity owner may be engaged in a trade or business, as defined for tax purposes. If the fund conducts a trade or business either directly or through a pass-through subsidiary of the fund that does not elect to be taxed as a corporation, income from that business will pass through to the tax-exempt organization equity owner as UBTI.\textsuperscript{14} An example of a trade or business includes the operation of a manufacturing or service business. UBTI also includes income from consulting fees earned by the private equity fund if produced by a business regularly conducted by the fund. These fees arguably include break-up fees, buyout closing fees, and equity commitment fees unless properly structured. However, loan commitment fees are exempt from this provision and therefore do not constitute UBTI.\textsuperscript{15} In contrast to active income, which tends to be taxable as UBTI, passive income is generally tax-free for tax-exempt organizations so long as it is not debt-financed. Generally this means that there will be no tax for a tax-exempt organization if the gains are from passive income sources such as interest, dividends, capital gains, real property rents, royalties, or sales of certain assets.\textsuperscript{16}

\textsuperscript{13} I.R.C. § 514; see also Treas. Reg. § 1.514(c)-1(a)(2), Ex. 4. However, these debt financing rules for unrelated business taxable income do not apply to certain qualified tax-exempt organizations, including pension plans and educational institutions, where the borrowing by the fund finances a specified type of investment in real property if certain requirements are met. However, these requirements are complex and difficult to meet. See I.R.C. § 514(c)(9).

\textsuperscript{14} Organizations that are generally exempt from federal income tax under I.R.C. § 501(a), such as charities, universities, and pension plans, are nevertheless subject to federal income tax on unrelated business taxable income, less deductions directly related to carrying on the trade or business. When a tax-exempt organization participates as a partner in a partnership, or as a member in an LLC, that carries on an active business “not substantially related . . . to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501,” I.R.C. § 513(a), then the exempt organization must report as UBTI its share of the gross income of the partnership or LLC, whether or not distributed. I.R.C. § 512(c)(1).

\textsuperscript{15} See I.R.C. § 512(b)(1).

\textsuperscript{16} See I.R.C. § 512(b).
If the income to the tax-exempt organization is from an active business, the income will generally be subject to federal income tax as UBTI. However, certain qualified pension plans and individual retirement accounts that do not want to file tax returns showing UBTI may invest in a private equity fund through an entity known as a “group trust,” provided certain requirements are met.17 By pooling their assets in a group trust, such investors can maintain the exempt status of their separate entities. A group trust may also qualify for tax-exempt status, but, in the case of UBTI, the group trust reports and pays tax on that income.

As an alternative to the group trust, tax-exempt organizations such as charities, universities, and pension plans (or private equity partnerships and LLCs that include tax-exempt investors) may form (or require the fund to form) “blocker corporations” to avoid the negative impact of UBTI. A blocker corporation is a corporation inserted into the structure which pays entity-level tax, thereby “blocking” the pass-through character of income/loss associated with a partnership. A blocker corporation can be utilized in at least three basic forms. First, tax-exempt investors can invest in a private equity fund through a corporation, which typically will be organized in a non-U.S. tax jurisdiction. The tax-exempt investors purchase shares from the blocker corporation, which becomes a limited partner or member of the fund, but the investors themselves do not directly become partners or members of the fund. Alternatively, such a blocker corporation may be formed to invest alongside the private equity fund in the investment that could otherwise generate UBTI. Under such arrangements, the blocker corporation would pay federal income tax on income “effectively connected” with a U.S. trade or business, as well as branch profits tax and withholding tax on interest and dividend income, but dividends distributed by the blocker corporation to the tax-exempt organization would not be taxed as UBTI. Finally, the private equity fund itself could make investments through a wholly owned subsidiary blocker corporation, with tax-exempt investors becoming limited partners in the fund directly. In certain cases, only the tax-exempt organization’s portion of the investment would be held through the blocker corporation. Each of these “blocker” structures has advantages and disadvantages that should be considered with tax counsel.

It is increasingly common for tax-exempt organizations to invest in funds that include investments that create UBTI. In these cases, the tax-exempt organization may require a ceiling on the percentage of the

fund’s capital commitments that may be invested in such assets. A typical request is that the fund limit these investments to 25% or 35% of the fund’s total equity commitments.\textsuperscript{18}

\textbf{[A][3] Tax Considerations for Foreign Persons}

Another benefit of the pass-through status of the partnership form is that foreign persons generally may potentially avoid U.S. federal income tax on their share of the private equity fund’s capital gains. Foreign persons generally are not taxed on such gain as long as (i) the gain received is not “effectively connected” with a trade or business in the United States conducted by the fund or by an operating pass-through entity in which the fund is an equity owner, and (ii) the gain is not from the disposition of a U.S. real property interest. A U.S. real property interest is, generally speaking, any interest in real property located in the United States and any interest in a U.S. company that has at least half of its assets in U.S. real property interests.\textsuperscript{19}

The tax treatment of foreign persons depends to some extent on the type of income generated by the fund. For capital gains, a foreign person is generally exempt from tax, subject to the limitations discussed immediately above. For ordinary income, however, there is a 30% withholding tax (subject to reduction by applicable tax treaties) on foreign persons for dividend and interest income (other than interest qualifying for the “portfolio interest” exception\textsuperscript{20}) not “effectively connected” with a U.S. business.\textsuperscript{21} For capital gains and ordinary income that are “effectively connected” with a U.S. business, the foreign person is subject to the same federal income tax as a U.S. person on such income.\textsuperscript{22}

Pursuant to legislation commonly referred to as “FATCA,” non-U.S. financial institutions, including offshore funds, will be required to disclose to the U.S. Internal Revenue Service account information of

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\textsuperscript{18} \textsc{Jack Levin}, \textsc{Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions} [Aspen 1999], ¶ 1001.1.
\textsuperscript{19} See \textsc{I.R.C.} § 897(c); \textit{see also} \textsc{Treas. Reg.} §§ 1.897-1 and 1.897-2.
\textsuperscript{20} See \textsc{I.R.C.} §§ 871(h) and 882(c).
\textsuperscript{21} See \textsc{I.R.C.} §§ 1441 and 1442. The specific withholding tax rate depends, \textit{inter alia}, on the applicable treaty governing the relations between the United States and the foreign person’s country of citizenship.
\textsuperscript{22} \textsc{I.R.C.} § 871(b)(1) provides that foreign individuals are taxed as provided in § 1 or § 55 on taxable income that is “effectively connected with the conduct of a trade or business within the United States.” Similarly, \textsc{I.R.C.} § 882(a) provides that a foreign corporation’s effectively connected income is taxed as provided in §§ 11, 55, 59A and 1201(a). Foreign investors often utilize blocker corporations in order to avoid filing a U.S. tax return and recognition of income “effectively connected” with a U.S. trade or business. The blocker corporation instead would file the return and report such income. \textit{See supra section 47:3.1[A][2].}
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direct and indirect U.S. investors, or be subject to U.S. withholding tax on dividend, interest, and proceeds from sales of U.S. securities.\textsuperscript{23}

[A][4] **Special Tax Issues for Sovereign Wealth Investors**

A sovereign wealth investor is generally an investment fund controlled and funded by a foreign government. In general, unlike other foreign persons, sovereign wealth investments by foreign governments are not subject to U.S. federal income tax, including withholding taxes, on income and gain.\textsuperscript{24} If the investment activities were to constitute commercial activities, however, a sovereign wealth investor would be subject to U.S. federal income tax.\textsuperscript{25}

[A][5] **Pass-Through of Losses to Equity Owners**

The partnership structure also generally allows a private equity fund to pass fund losses through to the individual limited partners, although limitations as to the use of such losses apply. In the early years of a fund when the management fees may exceed the fund income, this ability to pass-through losses may be materially beneficial to the limited partners. However, section 67 of the Internal Revenue Code limits deductions for a fund’s investment expenses passed through to an individual taxpayer if the fund is engaged in investment activity rather than an active business. An individual may deduct investment expenses that, combined with other itemized deductions, exceed 2% of adjusted gross income, assuming that the expenses are not deferred by the “at risk” rules of section 465 of the Internal Revenue Code or the “passive activity loss” rules of section 469 of the Internal Revenue Code.\textsuperscript{26} A limited partner that is organized as a corporation would not have this limitation apply to its investment expense deductions.

[A][6] **Tax-Free Distribution of Property to Equity Owners**

Another advantage of the partnership form is that a partnership can generally distribute cash or property to an equity owner tax-free to the extent such distribution (if cash or treated as cash) does not exceed

\begin{itemize}
\item \textsuperscript{24} I.R.C. § 892[a][1].
\item \textsuperscript{25} I.R.C. § 892[a][2]. A sovereign wealth investor also does not enjoy the exemption with respect to investments made in conjunction with commercial activities or made through a majority (or 50%) owned commercial entity.
\item \textsuperscript{26} I.R.C. § 67.
\end{itemize}
such equity owner’s adjusted tax basis in its partnership interest. The following treatment is afforded to the various categories of distributed property:

[A][6][a] **Cash**

Distributions of a certain amount of cash or cash equivalents from a partnership to a limited partner are generally tax-free to the extent the distribution does not exceed such limited partner’s adjusted basis in its partnership interest. Distributions in excess of a limited partner’s adjusted tax basis are treated as gain from the sale or exchange of such partner’s partnership interest.\(^\text{27}\) When a partnership distributes cash to an equity owner, the equity owner’s basis in the partnership interest is reduced by the amount of the cash received. Until the equity owner’s basis in the partnership interest is reduced to zero, the equity owner realizes and recognizes no gain on such distributions. However, once the basis is reduced to zero, any further distributions from the partnership will be subject to income tax. By contrast, all distributions of cash from a fund taxed as a corporation would be considered a dividend (to the extent of the earnings and profits of the corporation) and therefore taxable to an individual equity owner, although currently potentially taxable at capital gain rates if “qualified dividend income.”\(^\text{28}\)

[A][6][b] **Property**

Partnership distributions of appreciated property to limited partners are generally tax-free subject to certain rules that would impose tax depending on when that property, or other property, was contributed to the partnership that generally are not relevant in the private equity fund context.\(^\text{29}\) When a partnership distributes real or personal property to a limited partner, neither the partnership nor the equity owner recognizes any taxable gain. The equity owner takes a basis in the distributed property equal to the partnership’s adjusted basis in the distributed property, and such equity owner’s basis in its partnership interest is correspondingly reduced (but not below zero) by the same amount.\(^\text{30}\)

\(^{27}\) I.R.C. § 731(a).

\(^{28}\) I.R.C. § 1(h)(11). Also, if the shareholder receiving a distribution is itself a corporation, I.R.C. § 243 provides for either a partial or full “dividends received” deduction, depending on the relationship between the distributing corporation and the shareholder.

\(^{29}\) See I.R.C. §§ 704(c)(1)(B), 707(a)(2)(B), 731(b), 737.

\(^{30}\) I.R.C. §§ 732 and 733.
Marketable Securities

A distribution of marketable securities to an equity owner may be treated as a distribution of cash equal to the fair market value of the securities distributed. In such case, an equity owner that received marketable securities would first reduce his or her adjusted basis in the partnership interest by the fair value of the securities received, and any amount received that is greater than such total adjusted basis in the partnership interest would be treated as taxable gain. However, most private equity funds, particularly those that avoid investments in other pass-through entities, qualify to treat marketable securities as “property,” discussed in the prior subsection, which is generally more favorable tax treatment for the equity owners.

Tax-Favored Treatment of General Partner Carry

Currently, the tax law generally characterizes income earned on a general partner’s carry as having the character of underlying partnership income, principally capital gain in a private equity limited partnership. The tax treatment of partnership profits interests is more favorable than that of compensatory corporate stock or options on stock, where some element of compensation—ordinary income—is generally involved.

Periodically over the past several years, Congress has proposed, but failed to adopt, legislative provisions that would change the current tax treatment of a general partner’s carry from long-term capital gain to ordinary income. The Obama Administration supports such a change, but prospects for adoption are uncertain at this time.

31. I.R.C. § 731(c).
32. The American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. (2010), as originally introduced December 7, 2009 by Rep. Charles B. Rangel, contained a measure to change the tax treatment of carried interest, but as finally enacted as the Unemployment Compensation Extension Act of 2010, Pub. L. No. 111-205, 124 Stat. 2236, the law did not include any provisions affecting the taxation of carried interest. On September 16, 2010, Chairman Max Baucus introduced S. 3793, Job Creation and Tax Cuts Act of 2010, which included a proposal with respect to the taxation of carried interests that appears to be identical to the proposal in H.R. 4213. As of this writing, there has not been any legislative action with respect to the tax treatment of carried interest.
[A][8] Utility of Foreign-Situs Partnerships in Foreign Investments

Increasingly, private equity funds have made investments in foreign (non-U.S.) corporations. If the fund is in the form of a corporation or a domestic partnership, these foreign investments may generate adverse tax consequences under the “Subpart F” provisions of the U.S. Internal Revenue Code. The use of a foreign-situs partnership as the fund vehicle (or as a parallel fund vehicle or alternative investment vehicle) can ameliorate these concerns, but caution and careful planning is advised.

[B] Other Advantages of the Partnership Form

[B][1] Limited Liability

Historically, the limited liability of the limited partners in a limited partnership was often predicated on their not being engaged in the “control of the business,” which was the function of the general partner, and being so engaged could subject the limited partner to the general liability of a general partner. Since what constituted control for this purpose was largely interpreted by the courts based on very specific facts, certainty was not assured. In response, safe harbor provisions were included in state statutes specifying activities in which limited partners could engage without being deemed to participate in the control of the business. The limited partnership statute of Delaware, which has become the jurisdiction of choice for organizing private equity funds in the United States, includes an extremely broad safe harbor for activities by a limited partner which do not constitute control, including involvement far beyond that of typical private equity fund investors. Furthermore, the Delaware statute contains provisions specifically designed to protect the limited liability of the limited partner interests held by persons having interests in or operating the general partner. In effect, the Delaware statute reduces the liability of limited partners to an extent approaching the limited liability of shareholders in the corporate form.

34. A useful overview of the development of this concept is included in CRAIG B. SMITH & ANNE E. BOOKOUT, LIMITED PARTNERSHIPS: LEGAL ASPECTS OF ORGANIZATION, OPERATION AND DISSOLUTION 24-3d C.P.S. (BNA) at A-25 ff.
35. See 6 DEL. CODE ANN. § 17-303[b]. According to the leading authorities, if properly used in a well-drafted partnership agreement, § 17-303[1] provides unlimited flexibility and capacity for a limited partner to control the business of a limited partnership. MARTIN I. LUBAROFF & PAUL M. ALTMAN, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS § 5.4 (2005 Supp.).
36. See 6 DEL. CODE ANN. §§ 17-303[b](1) and (2).
In a limited partnership the general partner, as a rule, remains personally liable to third parties for the debts and obligations of the limited partnership. Private equity fund partnership agreements typically provide for indemnification of the general partner by the partnership. Accordingly, the value of the indemnity is limited to partnership assets, although generally fund agreements permit commitments to be drawn down, and often obligate limited partners to return some or all distributions received from the fund to fund the indemnity or other claims against the partnership. This limited partner obligation is referred to as a limited partner clawback. The partnership agreement may also limit the general partner’s liability to claims by the limited partners or the partnership through exculpation provisions. Typically, these provisions provide that the general partner will not be liable to the partnership or the other partners, except for fairly serious actions or omissions such as fraud, gross negligence, bad faith or intentional misconduct. Such conduct will also, typically, prevent the general partner from obtaining indemnification under the terms of the partnership agreement. The Delaware statute affords the parties broad authority by contract to define the liabilities of the general partner to the partnership and the other partners, to provide for indemnification, and to expand, restrict or eliminate the fiduciary duties of the general partner, the limited partners and other persons, except that the implied contractual covenant of good faith and fair dealing may not be eliminated. 37

The general partner will also typically be organized using a limited liability entity, or a series of limited liability entities. To further limit liability, the general partner will typically invest only a small portion of its funds as the general partner and will contribute the majority through a limited partner interest. Liability may be further reduced where a limited partner or a group of limited partners forms a corporation, a limited partnership, or an LLC to hold the limited partner interest in the fund.

§ 47:3.2 Limited Liability Company (LLC)

The LLC is a hybrid form of organization possessing some attributes of a partnership and some attributes of a corporation. In fact, the LLC combines the pass-through tax benefits of a partnership with the limited liability of a corporation. By 1997, all fifty states and the District of Columbia had adopted a statute permitting the use of the LLC form. The attractiveness of LLCs was significantly enhanced by a favorable 1988 U.S. Internal Revenue Service ruling that allowed an LLC to be taxed as a partnership. Under current Treasury Regulations,

37. See 6 DEL. CODE ANN. §§ 17-403(b), 108, and 1101(d) and (f).
an LLC with two or more members is, in general, automatically taxed as a partnership, achieving pass-through status. 38

LLCs are designed, by statute, to be extremely flexible. An LLC can easily be structured to resemble a limited partnership in its operations, with management authority and control over the business of the company vested in a manager or managing member who plays an operational role analogous to that of a general partner in a limited partnership, while the non-managing members can be given rights and obligations similar to those of limited partners. However, neither managers nor members of an LLC are personally liable for the debts of the LLC, unless they otherwise agree, unlike the limited partnership, which requires at least one general partner who will be personally liable for the obligations of the partnership.

[A] Tax Issues

Generally, unless the domestic LLC elects otherwise or the LLC is treated as publicly traded, 39 the LLC will be taxed as a partnership for federal income tax purposes. Most states also treat LLCs as partnerships for income tax purposes, although a few states impose entity-level franchise taxes or other taxes on LLCs, 40 but not on partnerships.

Foreign investors in certain countries may find it disadvantageous to invest in an LLC rather than a partnership. For example, because some foreign jurisdictions treat LLCs as corporations, an investor located in such a jurisdiction might be unable to claim the benefits of a tax treaty between that country and the United States because of the “hybrid” nature of the LLC, that is, a partnership for U.S. tax purposes and a corporation for foreign tax purposes. 41

[B] Liability Issues

State limited liability company statutes address two disadvantages of the limited partnership form, the requirement that one person (the general partner) have unlimited liability for the obligations of the partnership and the necessity of dealing with the “control of the business” doctrine, by generally providing a statutory shield against the liabilities of the company to all of the managers and members in their capacities as such. The Delaware limited liability company statute provides generally, for example, that the debts, obligations and liabilities of a limited liability company are solely those of the

38. Treas. Reg. § 301.7701-3[b][1].
39. See supra note 9.
40. See Bruce P. Ely, et al., State Tax Treatment of LLCs and LLPs—2011 Updates, in STATE TAX NOTES [May 9, 2011].
41. See, e.g., I.R.C. § 894(c) and the Treasury Regulations promulgated thereunder.
company, and that no member or manager is obligated personally for such debts, obligations and liabilities as a result of their status as a member or manager. Although the full extent to which the courts may determine that fiduciary obligations apply to members and managers in a limited liability company remains to be seen, the Delaware limited liability company statute, like the limited partnership statute, provides for the ability of the parties to expand, restrict or eliminate such duties by contract (except the implied contractual covenant of good faith and fair dealing).

[C] Partnerships Still Predominate

Despite the fact that the LLC form appears to offer the private equity fund several advantages, most funds are still organized as limited partnerships. There are several possible explanations for this. The first is inertia. Established fund sponsors may be reluctant to depart from a limited partnership agreement form that is familiar to their investor base. In addition, funds organized as limited partnerships are generally successful at avoiding entity-level taxes and providing limited liability for their investors. The LLC seems to offer a simplified way to achieve these same results, but there is a cost associated with making a transition and in educating investors. There may also be some lingering uncertainty as to judicial and regulatory treatment of LLCs in certain jurisdictions, while the law governing limited partnerships is well developed. Finally, as discussed in supra sections 47:2.1 and 47:3.2[A], a fund organized as an LLC may create tax issues for certain foreign investors or with respect to non-U.S. investments.

§ 47:4 ERISA Issues

Pension plans and other employee-benefit plans sponsored by employers and regulated by the Employee Retirement Income Security Act of 1974 (ERISA) are one of the primary sources of funding available to the managers of a private equity fund. There is, however, a risk associated with a pension plan or other retirement plan holding an interest in a private equity fund. The fiduciary duty requirements of ERISA always apply to the particular investments of the ERISA plan, and if ERISA is deemed to apply to all of the assets of a private equity fund (that is, the ERISA plan is deemed to own an undivided, individual interest in the fund assets as a whole), there may be

42. 6 DEL. CODE ANN. § 18-303(a). As with other forms of legal entities that provide limitations on liability, such as the corporation or limited partnership, other laws may, under certain circumstances, impose personal liability.

43. 6 DEL. CODE ANN. § 18-1101(b), (c), and (e).
significant negative repercussions that may unduly burden the fund. These ERISA requirements include: (i) fiduciary duty rules, including limits on self-dealing and prohibited transactions; (ii) reporting and disclosure regulations; (iii) limitations on incentive fees or other profit-based compensation; and (iv) other ERISA duties, such as bonding rules and liability provisions. ERISA imposes these strict fiduciary standards on the management of “plan assets” in order to safeguard those who participate in employee benefit plans. A private equity fund that has an ERISA plan as an investor must comply with ERISA fiduciary duty requirements for all assets of the fund associated with the ERISA plan unless the fund is specifically exempt from this requirement.\textsuperscript{44}

At first impression, the fiduciary duty owed to “plan assets” might not seem to pose an insurmountable problem for the fund. The portion of the fund that was owned by the ERISA plan would be owed certain extra fiduciary duties, as discussed below, but this would not prevent the fund from operating free of such duties with respect to the balance of the assets of the fund. However, section 3 of ERISA does not define the term “plan assets.” Therefore, the determination of what assets of the fund are included within the ambit of “plan assets” is left to the Department of Labor, which is charged with implementing the statute. The Department of Labor defines “plan assets” so broadly as to possibly include an undivided interest in all of the assets of a fund with an ERISA plan equity owner.\textsuperscript{45} In general, the rule is that when an ERISA plan invests in a debt instrument, the assets of the debtor do not become plan assets solely by reason of the investment. By contrast, an equity investment by an ERISA plan, such as a profits interest in a partnership or an equity interest in a corporation, results in “plan assets,” including an interest in the underlying assets of the fund (that is, the partnership or corporation) in which the plan invested, unless an exemption applies.

Absent an exemption from the ERISA plan asset rules, a typical fund with an ERISA plan investor will be subject to certain limitations. Section 404 of ERISA states that any person who “exercises any authority or control respecting management or disposition of

\textsuperscript{44} ERISA plans subject to this requirement include pension or profit-sharing plans sponsored by a domestic employer, other than a government entity, in the absence of an exemption. In addition, because certain states have statutes analogous to ERISA that apply provisions similar to many of the ERISA provisions to state pension plans, many state pension plans request the benefits and protections typically afforded to true ERISA plans by private equity funds.

\textsuperscript{45} Dep’t of Labor, Plan Assets Regulation, 29 C.F.R. § 2510.3-101(a)(2) (2000).
plan assets” must do so as a fiduciary to the beneficiaries of the plan. These fiduciary duties are described somewhat cryptically in ERISA sections 406(a)(1)(A)–(D) and 406(b). In practical terms, these fiduciary restrictions would make it quite difficult to effectively manage a private equity fund. For example, incentive fees, which are common in venture capital and buyout funds, may be effectively prohibited under ERISA.46 In addition, a fund holding ERISA plan assets may not engage in any transaction with any person who is a “party in interest” with respect to the ERISA plan. This includes, for example, an employer with employees participating in the plan, plan fiduciaries (including trustees and administrators), service providers to the plan, and any employee, 10% shareholder or 50% subsidiary of an employer or service provider. These restrictions would limit the ability of the fund to invest and operate on a day-to-day basis. A final example of the ERISA limitations involves the effect of plan investments in the fund on the ability of other fund investors to transact with the plan. A manager of a portfolio company whose assets are considered plan assets becomes a “party in interest” with the plan and its investors. This will restrict the ability of the manager and his or her affiliates to transact ongoing or future business with the plan. It also may require following this chain for the business operations of portfolio companies of other funds managed by the same sponsor, which may become untenable. Some, but not all, of these constraints can be alleviated by relying upon prohibited transaction exemptions promulgated by the Department of Labor.

Some funds have elected to operate as “plan asset funds,” managing their investments so as to comply with all of these ERISA restrictions. However, it is not necessary to do so in order to take advantage of the substantial source of investment capital offered by ERISA plan investors, provided that a private equity fund can qualify for one of the available exemptions from these onerous ERISA regulations.

Generally a fund with ERISA plan investors will use one of two exemptions from the fiduciary duty requirements of ERISA, either that: (i) the fund is a venture capital operating company (VCOC);47 or (ii) “benefit plan investors” hold an interest in the fund that is not “significant.” Such exemptions allow a private equity fund with an ERISA plan equity owner to avoid complying with the requirements of

46. See DEP’T OF LABOR, ADVISORY OP. 86-20A [Aug. 29, 1986] and DEP’T OF LABOR, ADVISORY OP. 86-21A [Aug. 29, 1986]. The Department of Labor seems to take the position that where a fiduciary [the management company] uses its powers to affect the amount or timing of any fee paid to the fiduciary, there is a violation of the self-dealing prohibitions of ERISA § 406(b).

47. A similar exemption is provided for real estate operating companies. 29 C.F.R. § 2510.3-101(e).
the Department of Labor, but care must be taken to ensure compliance with the specifics of the exemptions.

**Exemption 1:** If the fund is a VCOC, the fund is exempt from ERISA obligations. A VCOC is defined as a fund, at least 50% of the investments of which, measured by cost, are in qualified venture capital investments (that is, the fund invests in portfolio companies engaged in the production or sale of a product or service and the fund has specific contractual rights to substantially participate in or influence the conduct of the management of the portfolio company), and the fund actually exercises these management rights in the ordinary course of the fund’s business with respect to at least one portfolio company each year. It is common for a private equity fund seeking to qualify as a VCOC to demand a contractual right to representation on the board of directors or similar body of the portfolio companies in which it invests. Under the relevant ERISA provisions, this should ensure that the management obligation necessary to qualify as a VCOC will be met.

**Exemption 2:** As long as less than 25% of the value of each class of the equity interests of a fund are held by benefit plan investors, the fund will not be treated as a holder of plan assets and will be exempt.

48. The 50% test must be met at the time of the fund’s first long-term investment and annually thereafter. See Dep’t of Labor, Advisory Op. 96-26A (1996). However, the fund cannot qualify as a “VCOC” until such an investment is made. Therefore, the fund cannot accept investments from an ERISA plan without triggering ERISA fiduciary duties until the fund closes its first qualifying deal, unless the 25% test described in Exemption 2 with respect to benefit plan investors is met. A possible solution to this problem is to restrict or limit ERISA plan contributions to the fund until after the first qualifying investment either by contracting with the ERISA plan[s] that they will invest at a later date (with management fees and fund expenses payable to the management company rather than the fund) or by holding any ERISA plan contributions in escrow, or deferring them, until the first qualifying investment is complete.

49. See 29 C.F.R. § 2510.3-101(d)(1)(i), (d)(3)(ii). Where a board seat or similar representation cannot be obtained, other rights may suffice. In its Advisory Opinion 2002-01A (Mar. 26, 2002), the Department of Labor has stated that the following bundle of rights, which were represented to be more significant than those normally obtained by institutional investors in portfolio companies, was sufficient: (1) to receive detailed periodic financial reports; (2) to receive copies of all documents, reports, financial data and other information as may be reasonably requested; (3) to visit and inspect any of the properties of the portfolio company or any of its subsidiaries, including its and their books of account, and to discuss its and their affairs, finances and accounts with its and their officers, at such times as may be reasonably requested; and (4) to consult with and advise the management of the portfolio company and its subsidiaries, upon reasonable notice at reasonable times from time to time, on all matters relating to the operation of the portfolio company and its subsidiaries.
from ERISA fiduciary duties. A private equity fund that does not qualify as a VCOC generally will ensure that the holdings of each class of equity interests by benefit plan investors do not equal or exceed 25%. Ongoing monitoring, including in the context of transfers, is critical. Until the adoption of the Pension Protection Act of 2006 “benefit plan investors” for purposes of calculating the 25% included U.S. public pension plans and foreign pension plans. The 2006 Act made the 25% test more practical for private equity funds by limiting the investors who are deemed to be benefit plan investors for purposes of the 25% calculation to ERISA plans, IRAs and certain funds and accounts in which ERISA plans and IRAs invest.

Private equity funds typically are able to comply with the ERISA exemptions relatively easily. Most funds seek board representation as a condition of investment even without the ERISA requirements. They do so to exercise management influence in order to protect and maximize their investments. However, care must be taken in structuring investments intended to be qualified venture capital investments as multi-tiered structures may not meet the requirements.

Although the VCOC exemption is readily attainable by most private equity funds, the specific rules are complex, and a particular fund may be unable to qualify in each year. For such funds, the solution is to limit benefit plan contributions to less than 25% of the fund’s capital commitments. The drawback to limiting the fund to less than 25% investment from benefit plans is that it restricts the amount of benefit plan investment capital available to the fund.

§ 47:5 Securities Law Issues

In the context of a private equity fund, SEC registration issues arise on two levels: the first involves the issuance of interests in the fund in order to raise investment capital, the second involves offerings and issuances by the portfolio companies in which the fund invests.

A private equity fund raises money to invest in portfolio companies primarily, if not exclusively, by issuing investors an interest in the fund. The individual equity owner’s interest in the fund is typically evidenced by a limited partnership agreement for a limited partnership fund or a limited liability company agreement for an LLC fund. Each of these forms of ownership entitles the holder to participate in the

50. See 29 C.F.R. § 2510.3-101[f].
52. However, it is common for certain types of funds, particularly funds that provide mezzanine financing, to leverage their capital commitments [to borrow additional funds to invest as additional capital] in order to enhance returns.
profits of the fund and a right to receive distributions from the issuing entity. These fund interests generally are considered "securities" within the meaning of the Securities Act of 1933 (the "Securities Act"). The Securities Act requires that all securities offered or sold must be registered with the SEC unless the securities or the issuance of such securities falls within an exemption. Therefore, in the absence of an exemption, the fund would be required to comply with costly and time-consuming SEC registration procedures and public disclosure requirements applicable to companies that make a public offering of securities.

The requirements of the Securities Act also come into play at the level of the fund's portfolio companies. Most private equity funds typically invest in private portfolio companies. The portfolio companies will commonly issue stock or evidence of indebtedness to the fund. These securities are also subject to regulation under the Securities Act. Although it is the responsibility of the issuing company to comply with the SEC rules regarding privately placed securities, a private equity fund manager must also be aware of the securities law issues related to the securities of portfolio companies in which the fund invests.

Private equity fund and portfolio company offerings must also comply with any applicable state securities law requirements. Offerings made in compliance with Regulation D (discussed below) are preempted from state registration requirements although a notice filing may be required. In addition, reliance may be made on state private offering exemptions or institutional investor exemptions.

There are several possible federal exemptions available to both funds and portfolio companies that can be relied upon to allow them

53. Section 2(1) of the Securities Act defines "security" broadly to include "participation in any profit-sharing agreement" and "investment contract[s]" among other things. Furthermore, the cases interpreting the term security hold that nearly every investment contract where a "person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . ." is a "security" within the meaning of the Securities Act. SEC v. W.J. Howey Co., 328 U.S. 293 (1946). Under the so-called "Howey" test, this broad definition clearly includes equity investments in private equity funds.

54. Specifically, section 5(a) of the Securities Act prohibits the sale of a security without an effective registration statement filed with the SEC.

55. State private offering exemptions should be reviewed carefully to ensure that all applicable conditions will be met. Conditions may include limitations on the number of offers or purchasers in a state, suitability qualifications of purchasers, restrictions on the payment of commissions, and notice filings [post-sale, pre-sale or pre-offer]. Generally, offers and sales to institutional investors are exempt from state registration requirements under a separate exemption. If reliance is made on Regulation D, states generally require a notice filing when the filing of the Form D is made with the SEC.
to avoid the registration costs, delay and public disclosure burdens that registration under the Securities Act entails.

§ 47:5.1 Statutory Exemption: § 4(a)(2)

Section 4(a)(2) (formerly section 4(2)) of the Securities Act provides that the registration requirements of the Securities Act do not apply to the sale of securities not “involving any public offering.” However, the statute does not spell out the parameters for avoiding a public offering. The general parameters have been established through judicial decisions and SEC guidance over the years, but are not without ambiguity.\(^\text{56}\) Given the types of investors to whom interests in a private equity fund are typically offered and the limited nature of the typical private equity fund offering, the section 4(a)(2) exemption should generally be available for such an offering. However, a fund may choose to rely on the safe harbor exemptions for private placements established by the SEC discussed below.

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\(^{56}\) The criteria for complying with section 4(a)(2) are complicated. The following is a brief summary. In *SEC v. Ralston Purina Co.*, the Supreme Court held that whether or not an offering is a private placement (and therefore not subject to section 5 requirements) depends on whether the persons to whom the offering is being made “need the protection of the act.” *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). In that case, the Court found that the buyers of the securities in question were not shown to have “access to the kind of information which registration would disclose” and were therefore entitled to the protections of section 5 and its scheme of mandatory disclosure. The SEC subsequently clarified the requirements for a section 4(a)(2) private placement somewhat by providing a list of factors relevant to the question of whether the offerees need the safeguards of the Securities Act. These factors include: the identity of the offerees, the relationship of the offerees to the issuer, the size of the offering, the size of the units that comprise the offering, the use of intermediaries such as investment bankers or a stock exchange facility, the investment intent of the purchasers, demonstrated in part by the length of time the original purchasers held the securities, and the relationship of the offering to other offerings of the issuer. *See* Non-Public Offering Exemption, Securities Act Release No. 33-4552 [Nov. 6, 1962]. Despite the potential breadth of *Ralston Purina* and the SEC Release, two decisions by the Fifth Circuit in the early 1970s effectively narrowed the section 4(a)(2) exemption to only those “insiders” of the issuer who would be privy to all material information. *Hill York Corp. v. Am. Int'l Franchises, Inc.*, 448 F.2d 680 [5th Cir. 1971], *disapproved on other grounds by* Pinter v. Dahl, 486 U.S. 622, 651 [1988]; *SEC v. Cont'l Tobacco Co. of S.C.*, 463 F.2d 137 [5th Cir. 1972]. The issue about what exactly constitutes a private offering remains somewhat ambiguous. However, even where Regulation D is not formally complied with, if the offering is not made “publicly,” is limited primarily to sophisticated accredited investors, and sufficient information is made available, the private placement exemption under section 4(a)(2) should be available.
Whether a fund relies on the section 4(a)(2) exemption or the Regulation D safe harbor discussed below, the antifraud provisions of the Securities Act will apply to the offering of fund interests.

§ 47:5.2 Regulation D

The primary safe harbor from the registration requirements of the Securities Act is provided by Regulation D.\(^{57}\) Regulation D consists of Rules 504, 505, and 506, which provide exemptions for offerings limited to certain numbers and types of investors based on the dollar amount of the offering. Depending on the rule and the nature of the investors, varying levels of disclosure may be required (but generally less than what would be required in a registered offering). Because Rule 504 and Rule 505 offerings are limited in size to $1 million and $5 million, respectively, they are generally not useful to private equity funds. However, they may on occasion be relied upon by portfolio companies.

[A] Rule 506

Rule 506 is the most common Regulation D exemption relied upon by private equity funds. This is because offerings made under Rule 506 may be of an unlimited dollar amount and made to an unlimited number of investors who are “accredited investors” under the Rule, a standard which the typical institutional or wealthy individual investor in private equity funds generally meets.\(^{58}\) Even if the offering involves some non-accredited investors, the exemption may still be available because Rule 506 permits the offering to include up to thirty-five other investors who are not accredited but who meet financial sophistication.

\(^{57}\) Regulation D is a safe harbor that falls in part under section 3(b)(1) and in part under section 4(a)(2) of the Securities Act. Section 3(b)(1) provides that the SEC may issue exemptions from the registration requirements of section 5, as long as the total amount of the offering does not exceed $5 million. Rules 504 and 505 of Regulation D fall under the exemption provided by section 3(b)(1). Offerings under Rule 506 of Regulation D are considered “non-public offerings” under section 4(a)(2) and therefore are not restricted to the $5 million limitation of Rules 504 and 505.

\(^{58}\) The term “accredited investor” is defined in Rule 501(a) under the Securities Act. In the case of individual investors, the person must have a net worth in excess of $1 million or income in excess of $200,000 ($300,000 jointly with spouse) in each of the two most recent years and a reasonable expectation of reaching the same income level in the current year. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), Pub. L. No. 111-203, H.R. 4173, tit. IV, § 413(a) (July 21, 2010), available at http://docs.house.gov/rules/finserv/111_hr4173_finsrvcx.pdf, the value of a person’s primary residence must be excluded when calculating whether an individual has a net worth in excess of $1 million. The SEC subsequently amended the definition of net worth to exclude the value of the primary residence and to not include as a liability indebtedness secured by such primary residence, up to the fair market value of the residence.
criteria or use a sophisticated purchaser representative. Regulation D imposes a post-sale filing requirement.

There are no specific disclosure requirements for sales to accredited investors. However, any non-accredited investor must receive specific information a reasonable time before the sale. Historically, Regulation D imposed a general prohibition on advertising the offering and on “general solicitation” of investors, but the Jumpstart Our Business Startups Act, or the JOBS Act will eliminate this prohibition, provided that all purchasers (not offerees) pursuant to offers and sales under the Rule are accredited investors. The SEC has proposed rules to establish a new Rule 506(c) that would permit the use of general solicitation to offer and sell securities under Rule 506, provided that the issuer must take reasonable steps to verify that the purchasers are accredited investors, and all purchasers must be accredited investors or the issuer must reasonably believe they are accredited investors at the time of the sale. The proposal does not make clear what if any additional information will be required from investors, or what actions must be taken by the issuer, to verify accredited investors status, and has left that to the issuer to determine depending on the facts and circumstances. The proposed rules would leave intact Rule 506(b),

(except that indebtedness secured by the residence entered into within 60 days before the sale of securities is included as a liability unless it was used to purchase the residence). See Net Worth Standard for Accredited Investors, Securities Act Release No. 33-9287 [Dec. 21, 2011], 76 Fed. Reg. 81,793 [Dec. 29, 2011] (codified at 17 C.F.R. § 230.215). The Dodd-Frank Act also requires the SEC to adjust upward any net worth standard for individual accredited investors, effective four years after the enactment of the Act. Generally, entities (including trusts) must meet a $5 million total asset test and certain types of institutions, such as banks, insurance companies and registered investment companies, are accredited investors without being subject to a net worth or asset test. See 17 C.F.R. § 230.501[a]. See also Wolf, Block, Schorr and Solis-Cohen, SEC No-Action Letter, 1996 SEC No-Act. LEXIS 913 [Dec. 11, 1996], in which the SEC staff permitted the treatment of LLCs as accredited investors under Rule 501[a][3] subject to satisfaction of all other requirements of the definition.

A sophisticated investor is one who has sufficient knowledge and experience to be capable of understanding the merits and risks of a prospective investment.

See 17 C.F.R. §§ 230.502[c] and 503. Form D is filed electronically with the SEC fifteen calendar days after the first sale of securities in unregistered offerings under Regulation D. For this purpose, the date of first sale is the date on which the first investor is irrevocably contractually committed to invest. See SEC Compliance Guide, Filing and Amending a Form D Notice: A Compliance Guide for Small Entities and Others [Feb. 17, 2010]. The filed information is available on the SEC’s website.

See 17 C.F.R. § 230.502[b].


which provides for up to thirty-five non-accredited investors provided that there has been no general solicitation or advertising. The JOBS Act provides that transactions under the revised Rule 506 will not be deemed to be public offerings under the federal securities laws as a result of general advertising or general solicitation, and the SEC in its proposing release indicates that private funds will be able to avail themselves of general solicitation or general advertising when relying on the exemptions under section 3(c)(1) and 3(c)(7) of the Investment Company Act discussed in section 47:6 below. Therefore, private funds relying on section 3(c)(7) could make a general solicitation and rely on proposed Rule 506(c) when making an offering of fund interests, although it is likely that most such funds will continue to rely on Rule 506(b). The release also addressed the question of the impact of general solicitation under proposed Rule 506(c) under the Regulation S prohibition on directed selling efforts in the United States and indicated that a concurrent offshore offering conducted in compliance with Regulation S would not be integrated with a domestic offering conducted in compliance with Rule 506(c).64

Under the Dodd-Frank Act, the SEC is directed to adopt amendments to Regulation D that will impose a “bad actor” disqualification, so that issuers will be prohibited from relying on the Regulation D safe harbor exemption if the issuer or designated persons have committed specified bad acts within the prescribed time period.65 A fund prohibited from relying on Regulation D once the bad actor disqualification is adopted and effective would not be precluded from reliance on the section 4(a)(2) exemption.

A sale of securities meeting the requirements of Rule 506 is considered to be a sale “not involving a public offering” under the exemption of section 4(a)(2). Securities issued under this rule are restricted securities and may be resold only in transactions exempt from Securities Act registration, such as: (1) a subsequent private sale exempt from Securities Act registration; (2) a sale pursuant to Rule 144; (3) a public sale pursuant to a Regulation A offering statement filed with the SEC; or (4) an offshore transaction under Regulation S, offshore.
as long as there are no directed selling efforts in the United States, or in a public offering registered with the SEC under the Securities Act.

[B] Look-Through

In determining whether an investor is accredited, or needs to be counted toward the thirty-five-investor limit of non-accredited investors, it may be necessary to “look-through” an entity owner to its constituent owners. An entity that is “organized for the specific purpose of acquiring the securities” in question is subject to look-through from that entity to its equity owners.66 Thus, in a Regulation D offering under Rule 506 by a private equity fund, an investment partnership deemed to be organized for the purpose of investing in the securities of such fund would not count as one investor, but rather each equity owner of the partnership would count as an investor and must either be accredited or fall within the thirty-five non-accredited-investor limit for the offering. Thus, if the investor partnership was comprised of 100 members who were individuals or entities that did not qualify as accredited investors, the offering by the private equity fund would fail the Rule 506 requirement limiting non-accredited investors to thirty-five. However, members or equity owners of an investor entity that are accredited investors cause no potential problems for Regulation D offerings by private equity funds because Rule 506 allows an unlimited number of accredited investors.

The same analysis applies for a private equity fund that was arguably formed for the purpose of investing in a portfolio company. In this case, if the fund is compelled to look through to its equity owners, the portfolio company must take into account any non-accredited equity owners in the fund in determining its own compliance with the requirements of its Securities Act registration exemption.

Although Regulation D does not offer an objective test for determining when an entity is “organized for the specific purpose of acquiring the securities,” several factors are relevant: (1) the percentage of the entity’s assets used to buy the securities; (2) whether, when seeking investors, the entity announced to possible investors its intention to invest in the issuer; and (3) whether the entity is operated in such a manner as to facilitate individual equity owner decision making regarding investments.67

67. See, e.g., Hall Moneytree Assocs., SEC No-Action Letter, 1983 SEC No-Act. LEXIS 2961 (Nov. 3, 1983) (“No one factor will determine whether an entity should be regarded as organized for the specific purpose of making an investment. Any analysis of this issue must consider all facts and circumstances. Significant factors would include the existence and nature of prior activities by the entity, the structure of the entity [i.e., whether the entity has centralized management and decision-making], the proposed
Integration

Under the Securities Act, multiple related offerings may be required to be “integrated.” That is, the multiple offerings are treated as one offering in determining whether an exemption from registration is available. Unless the combined offering has been registered (which is not likely) or meets the requirements for an exemption, each of the constituent offerings is deemed to have violated the Securities Act. The doctrine of integration is intended to restrict the ability of issuers to evade the private placement restrictions by conducting a series of offerings to raise capital that each comply with the private placement restrictions but when considered as a whole do not. Similarly, under certain circumstances, the SEC will integrate a public offering, or attempted public offering, with a prior or subsequent private offering or attempted private offering. While integration is primarily a concern at the portfolio company level, it can also be a concern at the fund level.

The following factors are relevant to determining whether two or more offerings of securities should be integrated into a single offering: (1) whether the offerings are part of a single plan of financing; (2) whether the offerings involve the issuance of the same class of securities; (3) whether the offerings occur at about the same time; (4) whether the same type of consideration is received; and (5) whether the offerings are for the same general purpose. None of these factors is necessary or dispositive for two or more offerings to be integrated. Multiple sales of common stock or partnership interests to raise general investment equity that are offered within a short period of time, however, will likely be integrated into a single offering. If this is the case and the combined number of investors, dollar amounts, or sophistication requirements would violate Regulation D, the safe harbor exemption will not be available. To ameliorate the effects of the integration doctrine, Regulation D provides a safe harbor for offerings made more than six months before or more than six months after the completion of a Regulation D offering. Offerings made outside of these six-month windows will not be integrated with the offering in question. Similar integration issues will apply under the general section 4(a)(2) exemption, except the six-month safe harbor is not necessarily applicable. In addition, private offerings in connection

activities of the entity, the relationship between the entity’s investment in the Regulation D offering and the entity’s capitalization, and the extent to which all equity owners of the entity participate in all investments by the entity.”)

68. See Note to 17 C.F.R. § 230.502(a).
69. 17 C.F.R. § 230.502[a].
with compensatory benefit plans pursuant to Rule 701 and offshore offering transactions pursuant to Regulation S will not be integrated with Regulation D offerings.  

The SEC has adopted rules governing the integration of public and private offerings where one such offering is abandoned.  

Under these rules a private offering will not be considered a part of a later registered offering if: (a) no securities were sold in the private offering, (b) the issuer and any person acting on its behalf terminate all offering activity in the private offering before the issuer files the registration statement, (c) appropriate disclosure is made, and (d) thirty days have elapsed since the last private offering activity and the filing of the registration statement.  

Similarly, a later private offering will not be considered a part of an earlier registered offering if: (i) no securities were sold in the registered offering, (ii) the issuer withdraws the registration statement, (iii) appropriate disclosure is made, and (iv) the private offering is commenced thirty days or more after the date of withdrawal of the registration statement.

§ 47:5.3 Other Exemptions

Other exemptions under the Securities Act may be available to private equity funds, including Rule 701, Regulation A and...
exemptions for single state offerings.\textsuperscript{75} Like Rules 504 and 505 under Regulation D, however, these exemptions are typically not of great importance to larger private equity fund offerings because of their limited size and scope. Nevertheless, such exemptions may be useful to the portfolio companies of a fund.

If a fund is offering its interests to offshore investors, it may be able to rely on the registration exemption provided by Regulation S.\textsuperscript{76} Offers and sales that meet the Regulation S requirements need not comply with the Regulation D requirements, so that the accredited investor standard is not applicable. However, it is more common to see funds require all investors to meet the accredited investor standard under Regulation D in order to avoid the resale restrictions imposed by Regulation S.

Importantly for private equity and venture capital portfolio companies, the JOBS Act created a new category of “emerging growth companies.” An emerging growth company is generally defined to include U.S. or non-domestic issuers with less than $1 billion in annual gross revenues during their most recently completed fiscal year.\textsuperscript{77} Under the JOBS Act, emerging growth companies can take

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\item securities are offered and sold on a national securities exchange or sold to “qualified purchasers” as defined by the SEC. The new exemption is expected to change Regulation A in several other key respects, among them requiring annual audited financial statements, possibly requiring periodic disclosure, imposing section 12(a)(2) liability under the Securities Act, and expanding bad actor restrictions. The SEC is expected to modify Regulation A in light of the JOBS Act, but the JOBS Act did not set any time limit for the SEC to promulgate the new rules.
\item The key requirements of Regulation S are: (i) the transaction must be an “offshore transaction”—not involving an offer or sale to a person in the United States and the buyer is outside the United States at the time the buy order is originated; (ii) no “directed selling efforts” are made in the United States—no activities for the purpose of conditioning the market in the United States for the securities (such as general advertising); and (iii) “offering restrictions” are implemented for a one-year distribution compliance period—no resales in the United States or to a U.S. person unless the securities are registered or exempt under the Securities Act and the buyer agrees to resell only in accordance with Regulation S. See 17 C.F.R. §§ 230.900 et seq.
\item JOBS Act, Pub. L. No. 112-106 § 101. Issuers that first sold their common stock in an IPO on or prior to December 8, 2011, are ineligible to be considered emerging growth companies.
\end{itemize}
advantage of reduced regulatory requirements that ease access to public markets for up to five years. The benefits include the ability to submit confidential draft registration statements to the SEC prior to making a public filing, and to engage in pre-IPO communications with potential investors that are qualified institutional buyers or institutions that are accredited investors to gauge interest in investing in the company. Several other restrictions regarding IPO-related communications are also relaxed or removed for emerging growth companies. Once an emerging growth company has an IPO, it will be subject to reduced financial disclosure, governance, and accounting standard requirements.

§ 47:6  Investment Company Act of 1940

In addition to the Securities Act private placement rules, any sponsor launching a private equity fund must deal with the potential requirements of the Investment Company Act of 1940 (the ICA). In the absence of applicable exemptions, this Act could impose regulatory burdens on the fund and its manager that would make the usual private equity fund unworkable. Therefore, sponsors must give careful attention to complying with the applicable exemptions.

Absent an appropriate exemption, the ICA imposes significant registration and reporting requirements on “investment companies,” which term is broadly defined under the ICA. A private equity fund falls within the general definition of “investment company” for purposes of the ICA because the fund’s “primary activity” is “investing . . . in securities.”

Absent an exemption from being an investment company under the ICA, a fund would find itself and its investment activities subject to a complex and costly set of rules and regulations. The rules imposed on any non-exempt investment company include: (i) prohibitions against self-dealing; (ii) special fiduciary duty requirements; (iii) a requirement that at least 40% of the board of directors be comprised of disinterested persons; (iv) limits on the ability of the fund to implement policy changes, to enter into advisory contracts, or to implement other major business changes without investor approval; (v) specified capital structure for issuance of certain types of securities; (vi) limits on cash distributions without disclosure.

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78.–81. [Reserved.]
82. ICA § 3[a][1][A].
83. ICA § 17.
84. ICA § 36.
85. ICA § 10.
86. ICA §§ 13 and 15.
87. ICA § 18.
to investors,\(^8\) and (vii) certain administrative and bookkeeping requirements subject to SEC review.\(^9\) In addition, the ICA provides significant restrictions on transactions between investment companies and “affiliates,” including portfolio companies.\(^9\) These restrictions are generally inconsistent with the operation of a typical private equity fund. Therefore, it is imperative that the fund qualify for an exemption from regulation under the ICA. Funds usually rely on one of two exemptions from the ICA. The first is the “private investment fund” exemption provided by section 3(c)(1) of the ICA. The second is the “qualified purchaser fund” exemption afforded by section 3(c)(7) of the ICA.

**§ 47:6.1 Private Investment Fund Exemption**

The “private investment fund” exemption provided by section 3(c)(1) is a long-standing provision of the ICA, significantly amended by legislation in 1996. Under this exemption, a fund that has no more than 100 “beneficial owners” of its securities and has not made and does not plan to make any public offering of its securities is not considered an “investment company” within the meaning of the ICA,\(^9\) and is therefore exempt from all the provisions of the ICA. It is important to note that in order to rely on this exemption, the fund may have no more than 100 beneficial owners at the time of its creation and at all times thereafter: care must be taken to ensure that transfers or other changes in beneficial ownership over time do not cause the fund to lose its ability to rely on the exemption.

**[A] One Hundred Beneficial Owners Limitation**

Generally speaking, the number of beneficial owners of a private equity fund will be determined for section 3(c)(1) purposes by counting the number of individuals and entities purchasing interests in the fund. However, this counting exercise is rendered more complicated because in some circumstances entities must be counted as more than one beneficial owner (the so-called “look-through” requirements) and certain persons and entities connected with the sponsors need not be included in the count. It should be noted that a general partner interest

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\(^8\) ICA § 19.

\(^9\) ICA § 30.

\(^9\) ICA § 17.

\(^9\) The term “public offering,” as used in section 3(c)(1) (and section 3(c)(7)) of the ICA, has the same meaning that it has in section 4(2) of the Securities Act discussed supra section 47:5.1. Therefore the Regulation D safe harbor, discussed supra section 47:5.2, also applies in this context. Note that the JOBS Act is eliminating Regulation D’s previous restrictions against general solicitation and general advertising in connection with certain private placements of securities. See supra section 47:5.2.
as such is not generally considered to be a “security” and therefore may not have to be included in the count. However, if the general partner entity is used as a vehicle to provide indirect interests in the fund to passive investors who are not engaged in the management of the fund and who would not otherwise qualify as “knowledgeable employees” under the ICA rules (as described below), such investors may have to be included in the calculation of 100 beneficial owners.


Interests in private equity funds are often held through an entity or combination of tiered entities. For example, as discussed above in section 47:3.1[B][1], an individual or group of individuals might want to hold the interest through an LLC or an S corporation to provide limited liability protection while preserving pass-through income tax benefits. In such a case, it is possible that a single investor interest may actually be held by an entity comprised of numerous individual investors. The question then arises whether or not these individual investors are counted separately against the 100-investor maximum, or whether their single entity should count as only a single investor. While an entity is generally counted as a single beneficial owner, it is necessary to look through such entity to the entity’s underlying beneficial ownership in two circumstances.

[B][1] Automatic Statutory Look-Through

Under the automatic statutory look-through requirement of section 3(c)(1)(A) of the ICA, if the investor entity holds a 10% or greater voting interest in the fund and the investor entity is not an operating company, but is itself an investment company or an entity relying on the section 3(c)(1) private investment company exemption or the section 3(c)(7) qualified purchaser fund exemption, then the fund must count all the beneficial owners of the investor entity toward the fund’s 100-beneficial-owner limit.92 In the situation where a parent operating company has an investment vehicle subsidiary, such subsidiary is not subject to the automatic statutory look-through provision because the rules under the ICA exclude from the definition of investment company any company all of the securities of which are owned by a single operating company (that is, such subsidiary need not rely on the section 3(c)(1) or section 3(c)(7) exemptions).93

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92. ICA § 3[e][1][A]. The SEC staff generally treats a partnership interest as a voting interest for this 10% test where the partner is entitled to vote on removal of the general partner or any other significant matter.

93. 17 C.F.R. § 270.3a-3.
Secondary Look-Through Rules

Regardless of the ownership percentage that the entity has in the private equity fund, an entity investor is subject to a second level of look-through rules. Any entity investor “formed for the purpose” of investing in the private equity fund is subject to these secondary look-through provisions. Therefore, if an entity is created to invest in the fund it may be necessary to look through to that entity’s equity owners regardless of the stake that such entity holds in the fund. In a series of no-action letters, the SEC staff generally seemed to regard an investment of 40% or more of an entity’s assets in one fund as possibly giving rise to a finding that the entity was formed for such purpose, by conditioning its no-action relief upon a representation by investing entities that they would not invest more than 40% of their capital in any one section 3(c)(1) fund. Subsequently, the staff, while not repudiating its previous no-action letters regarding the 40% threshold, has stated that failure to comply with the 40% test is not automatically determinative, and that the analysis of whether an investor is “formed for the purpose” must be based on all of the surrounding facts and circumstances. A high percentage of ownership in a single fund remains an important factor in determining whether an entity may be deemed to be formed for the purpose of investing in that fund.

Similarly, if an investing entity is essentially a vehicle for implementing the individual investment decisions of its equity owners or participants, it will be necessary to look through the entity and count the individual equity owners or participants for purposes of the 100-person maximum. Such a look-through may be required where individual equity owners of the investment entity are empowered to determine whether or not the entity should invest in the fund or how much of each equity owner’s contributed capital should be invested in the fund. In addition, participants in participant-directed employee

94. Section 48[a] of the ICA provides that it is unlawful for any person to do indirectly through another person what it would be unlawful to do directly. Thus, a multi-tiered structure can be looked through if it is a sham or a conduit formed or operated to circumvent the provisions of the ICA.


benefit plans may have to be counted individually, particularly if they have the ability to elect participation in particular private equity funds. As discussed below in section 47:6.2, the SEC staff has clarified when a 401(k) plan subject to ERISA would not be subject to a look-through.

[C] Knowledgeable Employees

Recognizing that certain persons, due to their financial sophistication and relationship to the sponsor, do not require the protections of the ICA, the SEC rules permit “knowledgeable employees” to be excluded from the count. A “knowledgeable employee” is an individual who, at the time he or she acquired securities in the fund, was an executive officer, director, trustee, general partner, advisory board member, or person serving in a similar capacity, of the fund or of its general partner or management company. In addition, any employee of the fund or its general partner or management company who, as part of his or her regular functions or duties, participates in the fund’s investment activities (or the investment activities of another fund managed by the management company) will also qualify as a “knowledgeable employee” as long as the employee has been performing such functions or duties (or substantially similar functions or duties for or on behalf of another company) for at least twelve months. Entities owned exclusively by knowledgeable employees are also excluded from the count under the rule.

§ 47:6.2 Qualified Purchaser Fund Exemption

Alternatively, a fund may avoid the burdensome provisions of the ICA by meeting the requirements of the “qualified purchaser fund” exemption under section 3(c)(7), adopted as an amendment to the ICA in 1996. This exemption is available to a fund all of whose equity owners were “qualified purchasers” at the time they acquired the fund securities and the fund has not made, and does not plan to make, a public offering of securities. In fact, because a section 3(c)(7) fund is not limited to 100 beneficial owners, it is often preferable to a section 3(c)(1) fund, assuming all investors can satisfy the qualified purchaser requirements. An additional advantage of qualifying as a section 3(c)(7) fund is that the restrictions on performance fee

99. 17 C.F.R. § 270.3c-5(b).
100. 17 C.F.R. § 270.3c-5(a)[4][i].
101. 17 C.F.R. § 270.3c-5(a)[4][ii].
102. 17 C.F.R. § 270.3c-5(b)[2].

(Inv. Adv. Reg., Rel. #2, 10/12) 47–39
arrangements under the Investment Advisers Act of 1940 (the “Investment Advisers Act”) do not apply, as discussed below.

The ICA generally defines a “qualified purchaser” as an individual owning at least $5 million worth of “investments” or an entity owning at least $25 million worth of “investments.” Certain family-owned or related entities, and trusts not formed for the purpose of investing in the fund, all of the trustees and settlors of which are qualified purchasers, are subject to the $5 million minimum, as opposed to the $25 million minimum. In calculating the dollar thresholds,

1. married persons who own an investment jointly may both count the asset toward the $5 million total;
2. married persons who jointly invest in a fund may count all assets, whether or not jointly owned, toward the $5 million test;
3. assets held in retirement accounts such as an IRA may be counted; and
4. entity investors may include investment assets of majority-owned subsidiaries, any majority-owning parent, and any majority-owned subsidiaries of such parent.

A private investment fund or qualified purchaser fund that itself desires to invest in a qualified purchaser fund must meet an additional requirement: it may not be a qualified purchaser unless all of the investing fund’s security holders prior to May 1, 1996, consent to its treatment as a qualified purchaser. In addition, just as

103. See ICA § 2[a][51][A][i] and [iv]. “Investments” for both individuals and entities are defined to include securities and other assets held for investment purposes that, in the view of the SEC, demonstrate a significant degree of investment sophistication and experience on the part of the investor such that the investor has sufficient knowledge to be well-informed about the risks of investing in unregulated investment funds, including, e.g., real estate, commodity interests, physical commodities, cash and cash equivalents, and financial contracts but, in each case, only if held for investment purposes. An individual who controls a business cannot count securities in the business entity unless the entity has not less than $50 million in shareholder’s equity or is a public company. See 17 C.F.R. § 270.2a51-1 and Private Investment Companies, Investment Company Act Release No. IC-22405 (Dec. 18, 1996), 61 Fed. Reg. 68,100, at 68,103 (Dec. 26, 1996).

104. See ICA § 2[a][51][A][ii] and [iii].

105. ICA § 2[a][51]; 17 C.F.R. § 270.2a51-1(g)(2)-(4).

106. ICA § 2[a][51][C]. This includes pre-May 1, 1996 security holders of certain funds that beneficially own securities in the investing fund, directly or indirectly.
“knowledgeable employees” are not counted for purposes of the section 3(c)(1) exemption, they may invest in a qualified purchaser fund without meeting the definition of a qualified purchaser. 107

Importantly, tandem section 3(c)(7) and section 3(c)(1) funds are not integrated for purposes of qualifying for the exemptions from the ICA. 108 Thus, a single group of fund managers may organize one fund that satisfies the private investment fund exemption and another fund that meets the qualified purchaser fund exemption, and then invest these funds in tandem. For example, knowledgeable employees may own and operate a management company that serves as general partner for a fund which has up to 100 non-qualified purchaser investors. This fund falls under the section 3(c)(1) or “private investment fund” exemption. Simultaneously, these same knowledgeable employees may own and operate another management company that serves as general partner for a second fund with an unlimited number of qualified purchasers. This fund falls under the section 3(c)(7) or “qualified purchaser fund” exemption. The result is that an investment manager may form two independent funds which invest together under the management of a single group of knowledgeable employees. For purposes of the ICA, these funds together may have an unlimited number of qualified purchasers, an unlimited number of knowledgeable employees, and 100 other investors. The number of investors in a private equity fund, however, may be limited by other regulatory considerations. For example, a fund with assets exceeding $10 million will want to limit their holders of record to fewer than either 2,000 persons or 500 persons who are not accredited investors so that the fund will not be required to register under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). 109

The secondary look-through rules applicable to section 3(c)(1) funds also apply to section 3(c)(7) funds. Thus, if an entity is deemed to be formed for the purpose of investing in a section 3(c)(7) fund, because, for example, its equity-holders are making individual decisions to

107. 17 C.F.R. § 270.3c-5.
108. ICA § 3(c)(7)(E).
109. See JOBS Act, Pub. L. No. 112-106 § 501; Exchange Act § 12(g). Prior to the JOBS Act, issuers with 500 holders were required to be registered under the Exchange Act. Under the JOBS Act, securities held by persons who received the securities pursuant to an employee compensation plan in a transaction exempted from the Securities Act do not count towards this limit [prior to the JOBS Act such holders were counted towards the limit]. Pub. L. No. 112-106 § 502. In addition, subject to SEC rulemaking due 270 days after enactment of the JOBS Act, securities held pursuant to crowdfunding, discussed supra section 47:5.3, will not count towards this limit. Id. at § 303.
invest in the section 3(c)(7) fund, those equity-holders would themselves have to be qualified purchasers.

The SEC staff has clarified when a fund may look to a 401(k) plan as a whole versus when the fund must “look through” the 401(k) plan to its employee participants for purposes of satisfying the qualified purchaser test.\footnote{110} A section 3(c)(7) fund should “look through” a participant-directed plan in which each employee may invest through the plan in a generic investment option consisting of a section 3(c)(7) fund and may determine whether and how much to invest in the section 3(c)(7) fund, because in that case each employee “is acting for his or her own account and must meet the definition of qualified purchaser.”\footnote{111} In contrast, the 401(k) plan itself, rather than its individual participants, may satisfy the “qualified purchaser” requirement when: (1) a plan participant’s investment discretion is limited to allocating his or her account among investment options with generic investment objectives,\footnote{112} (2) the decision to invest funds allocated to a generic investment option in a section 3(c)(7) fund and the amount invested is made by the plan trustee or other plan fiduciary without direction from or consultation with plan participants, (3) at least 50% of the assets of a particular 401(k) investment option consist of securities or property other than securities of the section 3(c)(7) fund, and (4) no representations will be made to plan participants that any specific portion of their contributions to or account balances under the plan, or any specific portion of an investment option, will be invested in the section 3(c)(7) fund.\footnote{113}

§ 47:7 Investment Advisers Act of 1940

A private equity fund is typically managed by a general partner, managing member or affiliated management company. However structured, the manager identifies investments, negotiates and structures transactions, monitors the fund’s portfolio companies, and often contributes other expertise to the portfolio companies in which the fund has invested. This role is crucial for the fund’s success and is the basis on

\footnotesize{\begin{itemize}
\item \footnote{110}{H.E. Butt Grocery Co., SEC No-Action Letter, 2001 SEC No-Act. LEXIS 578 [May 18, 2001].}
\item \footnote{111}{Id. at 15.}
\item \footnote{112}{The SEC approved of the fact that the discretion of a 401(k) plan participant was limited to allocating his or her account among a number of investment options, each of which had an identified generic investment objective, such as an “aggressive” fund, a “general” fund, or a “conservative” fund. \textit{Id.} at 3, 21, 26.}
\item \footnote{113}{\textit{Id.} at 16–17, 21 & n.25.}
\end{itemize}
which a fund is raised, but it also has attendant regulatory consequences. The Investment Advisers Act regulates “investment advisers,” an adviser being defined as a “person who, for compensation, engages in the business of advising others . . . as to the advisability of investing in, purchasing, or selling securities. . . .” 114 Although the management company’s role in a buyout or venture capital fund is arguably broader than simply providing advice regarding the purchase or sale of securities, the SEC generally views a fund manager as coming within the definition of an “investment adviser” subject to SEC regulation.

Prior to the implementation of the Dodd-Frank Act, 115 signed into law on July 21, 2010, many advisers to private equity funds were not required to be registered under the Investment Advisers Act in reliance on the exemption provided under former section 203(b)(3) for an adviser that during the course of the preceding twelve months had fewer than fifteen clients and did not hold itself out generally to the public as an investment adviser. However, the Dodd-Frank Act eliminated this exemption effective July 21, 2011. As a result, investment advisers to private equity funds were required to be registered with the SEC by March 30, 2012, 116 unless one of the limited exemptions of the Dodd-Frank Act applies or the investment adviser is precluded from registering with the SEC because it does not meet the applicable jurisdictional thresholds (generally based on assets under management) and is consequently subject to state registration requirements.

§ 47:7.1 New Jurisdictional Provisions and Exemptions Under Dodd-Frank


Subject to certain transition rules, the Investment Advisers Act, as amended by the Dodd-Frank Act, generally requires an investment adviser that manages at least $100 million in assets to register with the SEC unless it qualifies for a registration exemption, and advisers with less than $100 million in assets under management are generally precluded from registering with the SEC and will be subject to state

114. IAA § 202(a)(11).
115. Dodd-Frank Act, H.R. 4173, supra note 58.
registration requirements.117 For this purpose, assets under management are measured by their market or fair value on a gross basis and include committed capital.118 For investment advisers with between $25 million and $100 million in assets under management, if the law of the state in which the adviser has its principal office and place of business provides an exemption from registration for the investment adviser and the investment adviser does not register with the state, or if the investment adviser is subject to registration with the state but the state has not confirmed that it examines advisers, the investment adviser is subject to registration with the SEC.119 Investment advisers with between $25 million and $100 million of assets under management that would otherwise be required to register with fifteen or more states may opt to register with the SEC.120 Advisers with less than $100 million in assets under management that are currently registered with the SEC in reliance on the jurisdictional thresholds in effect prior to the Dodd-Frank Act had until June 28, 2012, to withdraw their registrations.

[B] Exemptions from Registration

The Dodd-Frank Act exemptions applicable to U.S. and foreign advisers to private equity funds are the exemptions for an investment adviser solely to one or more venture capital funds and the exemption for advisers who solely advise private funds with limited assets under management. The fact that both exemptions are available to advisers who act “solely” in the applicable capacity will reduce their utility. In

117. Investment Advisers Act § 203A[1][2]. State-regulated advisers with less than $25 million in assets under management are generally precluded from federal registration. See Investment Advisers Act § 203A[1][1][A]. Amended Rule 203A-1[a] under the Investment Advisers Act provides a “buffer” for advisers with over $25 million in assets under management that are close to $100 million to determine whether and when to switch between state and SEC registration: such a manager with more than $100 million but less than $110 million is not required to register with the SEC, and an SEC-registered adviser is not required to withdraw from registration until it has less than $90 million of assets under management. See 17 C.F.R. § 275.203A[a] and Investment Advisers Act Release No. IA-3221, supra note 116.


119. 17 C.F.R. § 275.203A-1. Currently, only New York has not confirmed that it subjects advisers to examination. See Investment Advisers Act Release No. IA-3221, supra note 116, at 39. Wyoming does not have a law requiring the registration of investment advisers so all advisers with their principal office and place of business in Wyoming are subject to registration with the SEC, regardless of their amount of assets under management.

120. 17 C.F.R. § 275.203A-2[d].
addition, the Dodd-Frank Act provides a very limited exemption for foreign private advisers.

[B][1]  Venture Capital Fund Exemption

The Dodd-Frank Act did not define the term “venture capital fund,” but directed the SEC to issue rules defining the term. Under the rule adopted by the SEC, the definition of “venture capital fund” is drawn narrowly.\textsuperscript{121} Under new Rule 203(1)-1, to qualify as a “venture capital fund,” a fund may only invest in “qualifying investments” and short-term holdings, subject to a basket for non-qualifying investments of 20% of the fund’s capital commitments.\textsuperscript{122} Under the rule, “qualifying investments” are generally investments in equity securities of a “qualifying portfolio company” that are acquired by the fund directly from the qualifying portfolio company or, in limited circumstances, in exchange for such directly acquired equity securities.\textsuperscript{123} Thus, non-equity securities and securities acquired from existing investors would not generally qualify.

The rule defines a “qualifying portfolio company” as basically having three characteristics.\textsuperscript{124} First, based on the SEC’s understanding that venture capital funds generally invest in private companies, a qualifying portfolio company cannot be a “reporting or foreign traded company,” which generally means a public company for purposes of the Exchange Act or a company that is publicly listed on a non-U.S. exchange or market, or in a control relationship with a reporting or foreign traded company at the time of the investment by the fund. The test is applied at the time of investment because venture capital funds often exit portfolio investments by means of initial public offerings. Secondly, a qualifying portfolio company cannot incur leverage in connection with the investment by the fund and distribute to the fund the proceeds of the leverage in exchange for such investment, which is an investment technique typical of leveraged buyout funds. Finally, the qualifying portfolio company cannot itself be a fund or commodity pool, including a fund of venture capital funds. In addition, to qualify as a venture capital fund, a fund must generally be a private fund (that is, a 3(c)(1) fund or a 3(c)(7) fund) that does not borrow or otherwise incur leverage, except for certain short-term borrowing not in excess of 15% of the fund’s aggregate capital

\textsuperscript{122} 17 C.F.R. § 275.203[l]-1(a)(2).
\textsuperscript{123} 17 C.F.R. § 275.203[l]-1(c)[3].
\textsuperscript{124} 17 C.F.R. § 275.203[l]-1(c)[4].
contributions and uncalled capital commitments; represents to investors and potential investors that it pursues a venture capital strategy; does not permit its investors to redeem their interests except under extraordinary circumstances; and is not registered under the ICA and has not elected to be treated as a business development company under the ICA.\textsuperscript{125}

The new rule also contains a grandfather provision for certain funds that were marketed as venture capital funds and closed prior to the July 21, 2011 effectiveness of the Dodd-Frank Act, in recognition of the operational difficulties a previously existing venture capital fund may face in meeting the new rule’s definition of venture capital fund.\textsuperscript{126} Because the exemption is defined largely in terms of the investments of the fund (and how its investment strategy is presented), investment advisers relying on the venture capital fund exemption will need to monitor their client fund investments and descriptions of the strategy of the fund carefully in light of the definitions and interpretations under the SEC’s rules to determine compliance with the exemption.

\begin{itemize}
  \item [B][2] Private Fund Exemption
  
  With respect to advisers to smaller funds, the Dodd-Frank Act directed the SEC to provide an exemption for an investment adviser solely to one or more 3(c)(1) or 3(c)(7) funds with aggregate assets under management in the United States of less than $150 million, referred to by the SEC as the private fund adviser exemption.\textsuperscript{127} As noted above, assets under management are measured by their market or fair value on a gross basis and include committed capital. While of limited utility to U.S. investment advisers, other than those U.S. investment advisers who limit their clients to relatively small 3(c)(1) and 3(c)(7) funds, the rule promulgated for this exemption by the SEC permits a non-U.S. adviser (an adviser with a principal office and place of business outside the United States) to count only private fund assets it manages at a place of business in the United States toward the $150 million cap. Thus an adviser with its principal office and place of business outside the United States, whose only U.S. clients are 3(c)(1) or 3(c)(7) funds, could manage an unlimited amount of assets held by such funds and not be required to register as long as all assets managed by the investment adviser at a place of business in the United States are attributable to those funds, and the total of such assets managed at

\textsuperscript{125} 17 C.F.R. § 275.203(l)-1[a].

\textsuperscript{126} 17 C.F.R. § 275.203(l)-1[b].

\textsuperscript{127} Dodd-Frank Act, tit. IV, § 408 and see Investment Advisers Act Release No. IA-3221, \textit{supra} note 116.
a place of business in the United States is less than $150 million. The type or number of its non-U.S. clients and the amount of assets managed outside of the United States do not affect the ability of the non-U.S. adviser to rely on the private adviser exemption.

[B][3] Foreign Private Adviser Exemption

The Dodd-Frank Act also provides a narrow and complex exemption for “foreign private advisers.” The Dodd-Frank Act defines this term as an adviser who: (a) has no place of business in the United States; (b) has fewer than fifteen clients and investors in the United States in 3(c)(7) or 3(c)(1) funds advised by the adviser; (c) has aggregate assets under management attributable to clients in the United States and investors in the United States in such funds of less than $25 million; and (d) does not hold itself out generally to the public in the United States as an investment adviser or act as an investment adviser to an investment company registered under the ICA or a business development company as defined in the ICA. To rely on this exemption, investment advisers will be required to count the U.S. investors in a 3(c)(7) or 3(c)(1) fund managed by the investment adviser, even if that fund is organized outside the United States. This “look-through” requirement does not apply to a fund managed by the investment adviser that is not a 3(c)(1) or 3(c)(7) fund.

[B][4] Exempt Reporting Advisers

As noted above, given the limited exemptions available under Dodd-Frank, it is likely that most advisers to private equity funds will be required to be registered. Moreover, investment advisers relying on the venture capital fund exemption and the private fund adviser exemption (“exempt reporting advisers”), including non-U.S. advisers relying on the private fund adviser exemption, are still required to file and update a shortened version of Part 1 of Form ADV, including information about the funds they manage, and are subject to the anti-fraud provisions of the Investment Advisers Act.

128. See 17 C.F.R. § 275.203[m]-1(b) and Investment Advisers Act Release No. IA-3221, supra note 116.
130. Dodd-Frank Act, tit. IV, § 402, IAA §§ 202[a][30] and 203[b][3].
131. Dodd-Frank Act, tit. IV, § 402. The SEC has also adopted a rule to exclude a “family office” from the definition of investment adviser under the Investment Advisers Act. Id. § 409. See Family Offices, Investment Advisers Act Release No. IA-3220 [June 22, 2011].
§ 47:7.2 Consequences of Registration

The Investment Advisers Act imposes two significant burdens on investment advisers unless applicable exemptions are available. First, “investment advisers” must register with, and are subject to inspection by, the SEC. Second, while compliance with the substantive rules applicable to registered investment advisers is onerous, it would generally not be fatal for advisers to private equity funds to be registered, except that, absent an exemption, a registered adviser (or an adviser required to be registered) is forbidden from receiving “compensation . . . on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.” 133 The restrictions on performance-based compensation would prohibit the fund manager from receiving the carried interest, which is an integral component of the fee structure for a private equity fund. Therefore, it is important that an adviser to a private equity fund that is required to register under the Investment Advisers Act qualify for an exemption from the restrictions on performance-based fees.

Because many private equity fund general partners and managers are not registered, investment advisers and their operations have not been organized with a view toward the formal and technical requirements of the Investment Advisers Act. While a detailed discussion of the requirements the Investment Advisers Act imposes on registered advisers is beyond the scope of this chapter, a few observations are in order. In connection with registering as an investment adviser, it is imperative for the adviser to carefully prepare and receive expert advice. Registered investment advisers are required to adopt compliance programs and codes of ethics, 134 which encompass many aspects of the firm’s business. As discussed below, the Dodd-Frank Act imposes new reporting and recordkeeping requirements on registered investment advisers to private equity funds.

Compliance Programs. The Investment Advisers Act requires every registered investment adviser to adopt and implement written policies and procedures reasonably designed to prevent violations of the Investment Advisers Act and the rules promulgated thereunder. 135 The SEC has emphasized that compliance programs should be tailored to the nature of the business of the adviser. The first task is to identify conflicts of interest and other compliance factors creating risk exposure for the firm and its clients in light of the firm’s particular operations, and then design policies and procedures that address those risks. This task requires familiarity with all of the business activities of the adviser, including the investments and investment strategies that

133. Investment Advisers Act § 205(a)(1).
135. 17 C.F.R. § 275.206(4)-7(a).
the adviser implements on behalf of the private equity funds it advises and the other funds or clients the adviser serves. Care needs to be given to designing policies and procedures that address the substantive requirements of the Investment Advisers Act and that can be effectively implemented by the organization. Moreover, this is not a static process. Under the Investment Advisers Act, registered investment advisers are required to undertake a review of their compliance policies and procedures on at least an annual basis, and it is advisable to be sensitive to changes in the business of the adviser and to identify and address potential new compliance risks as they arise. In the current environment, a careful review of the firm’s compliance program should include matters such as proper disclosure of the adviser’s activities and conflicts of interests, accurate performance claims, monitoring custody arrangements, and ensuring that the compliance program has adequate resources to fulfill its mandate. The failure to meet these requirements will be identified during an SEC inspection. SEC inspections may be lengthy and require significant attention from the adviser’s personnel.

The Investment Advisers Act requires that each registered investment adviser appoint a chief compliance officer to administer the adviser’s compliance policies and procedures. The chief compliance officer should be knowledgeable regarding the Investment Advisers Act and empowered with the authority to develop and enforce the adviser’s compliance policies and procedures. As such, the chief compliance officer should hold a position of sufficient authority within the firm to compel the adviser’s personnel to comply with the adviser’s compliance policies and procedures.

*Code of Ethics.* As noted above, the Investment Advisers Act requires a registered investment adviser to adopt and enforce a written code of ethics. The Investment Advisers Act provides that the code of ethics must include certain minimum provisions regarding matters such as standards of business conduct and compliance with federal securities laws. An adviser’s code of ethics must also require certain personnel deemed “access persons” to report to the adviser their personal securities holdings and transactions, including transactions in mutual funds advised by the adviser or an affiliate. The chief compliance officer (or other person designated in the code of ethics) is

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136. 17 C.F.R. § 275.206[4]-7(b).
138. 17 C.F.R. § 275.206[4]-7(c).
139. 17 C.F.R. § 275.204A-1.
140. 17 C.F.R. § 275.204A-1[b].
required to review these reports.\textsuperscript{141} The code of ethics must also require that each access person obtain prior approval before acquiring securities in an initial public offering or certain private placements.\textsuperscript{142}

In addition to preparation of the compliance policies and procedures and the code of ethics, it will be necessary to train the appropriate personnel in the implementation of the policies and procedures adopted.

Some of the other Investment Advisers Act requirements for registered investment advisers are:

\textit{Form ADV.} All applicants for registration as an investment adviser must prepare a Form ADV.\textsuperscript{143} This document is the investment adviser registration form and requires disclosure of information such as the applicant’s disciplinary history, types of fees charged, advisory services provided, and background of advisory personnel. Form ADV consists of Part 1 and Part 2, as well as any required schedules. Both Parts 1 and 2 have recently been substantially revised by the SEC.\textsuperscript{144} Both Parts 1 and 2A are filed electronically with the Investment Adviser Registration Depository (the IARD) and are publicly available. The current Part 2 includes Part 2A, the “Brochure” and an Appendix 1 to Part 2A, the “Wrap Fee Program Brochure,” and Part 2B, the “Brochure Supplement.”\textsuperscript{145} Part 2A replaces the previous “check-the-box” approach of old ADV Part II with a narrative brochure in plain English, and includes information regarding the adviser’s business, fees and other compensation, types of clients, investment strategies and risks of loss, disciplinary actions, various conflicts of interest and how they are addressed, and other information. The ADV Part 2 must be delivered to advisory clients with respect to private equity funds, but the fund itself is the “client” for this purpose, not the investors in the fund. Under Dodd-Frank, the SEC has the authority to define “client” to mean fund investors for purposes of the delivery requirements.\textsuperscript{146}

The Brochure Supplement must be delivered with each Brochure and provides information regarding supervised persons of the adviser, which include the adviser’s officers, partners, directors, or employees, whom the client relies on for investment advice. The Brochure Supplement is required to be delivered to “clients” but not to be filed with the SEC or made publicly available.

In revising the Form ADV Part 1, the SEC expanded the disclosure requested with respect to private funds to provide further information.

\begin{footnotesize}
\begin{itemize}
\item[141.] 17 C.F.R. § 275.204A-1[a]{(a)}.
\item[142.] 17 C.F.R. § 275.204A-1[c].
\item[143.] 17 C.F.R. § 275.203-1[a].
\item[144.] For the revisions to Part 2, see Amendments to Form ADV, Investment Advisers Act Release No. IA-3060 (July 28, 2010). For the revisions to Part 1, see Investment Advisers Act Release No. IA-3221, \textit{supra} note 116.
\item[145.] \textit{See} Investment Advisers Act Release No. IA-3060, \textit{supra} note 144.
\item[146.] Dodd-Frank Act, tit. IV, § 406.
\end{itemize}
\end{footnotesize}
about each private fund managed, including information regarding the fund’s organization, gross assets and investment strategy (based on an enumerated list of potential categories, for example, “private equity fund”), as well as disclosure as to the fund’s auditors, prime brokers, custodians, administrators, marketers and any other investment adviser to the fund.147

The rule adopting the new Part 1 also creates a new reporting regime for “exempt reporting advisers,” that is, advisers relying on either the venture capital fund adviser exemption or the private fund adviser exemption. These unregistered advisers will be required to report on Form ADV the information noted above relating to private funds they manage as well as identifying information about their owners and affiliates, business activities that may present conflicts of interest, and disciplinary information for the adviser and its employees. An exempt reporting adviser was required to file its initial report on Form ADV with the SEC no later than March 30, 2012.148

A registered investment adviser is required to amend its Form ADV periodically and (other than the Brochure Supplement) at least annually, and an exempt reporting adviser is required to amend its Part 1 periodically and at least annually, to update or correct its content.149

Advisory Contracts. The Investment Advisers Act regulates certain specific aspects of a registered investment adviser’s contracts with advisory clients. For example, the advisory contract must provide that the adviser may not “assign” the contract without the consent of the other party.150 The definition of “assignment” set forth in the Investment Advisers Act is quite broad. Moreover, the Investment Advisers Act prohibits waiver of compliance with the Investment Advisers Act in advisory contracts.151 The Investment Advisers Act also mandates that if the investment adviser is organized as a partnership, the advisory contract must provide that the adviser will notify the client within a reasonable period of time after any change in the membership of the adviser.152 It will be necessary to review existing agreements and forms in connection with registering.

Custody. A registered investment adviser that is deemed to have custody of client securities or funds is subject to certain additional requirements. An adviser is deemed to have custody of client assets when it holds, directly or indirectly, client funds or securities or has any authority to obtain possession of them.153 Accordingly, most

148. See id.
149. 17 C.F.R. § 275.204-1(a).
150. Investment Advisers Act § 205(a)(2).
152. Investment Advisers Act § 205(a)(3).
153. 17 C.F.R. § 275.206(4)-2(c)(1).
registered advisers have custody for purposes of the Investment Advisers Act. An adviser with custody of client funds and securities must maintain them with a “qualified custodian,” provide certain notices to clients and provide, or cause to be provided, certain periodic account statements to clients (and investors in limited partnerships or LLCs).

For private equity funds, the account statement delivery requirement can be met by providing the annual audited financial statements of the fund to the fund investors within 120 days of the end of the fiscal year of the fund, provided that the audit is conducted by an auditor registered with and subject to inspection by the Public Company Accounting Oversight Board. If a fund is unable to satisfy the audit requirements, complying with the custody rule may pose practical challenges.

Advertisements. The SEC is particularly sensitive to advertisements by registered investment advisers, and the term “advertisement” is defined quite broadly in the Investment Advisers Act. The Investment Advisers Act prohibits various advertising practices by registered investment advisers. For example, the Investment Advisers Act generally prohibits any investment adviser from distributing advertisements that refer to any testimonial regarding the adviser or any advice or other services rendered by the adviser. Moreover, the Investment Advisers Act prohibits advertisements referring to past specific recommendations by the adviser unless the advertisement meets certain detailed criteria. The Investment Advisers Act also prohibits advertisements that contain an untrue statement of a material fact or that are otherwise false or misleading. Pre-registration preparation should include a review of offering materials.

Record-keeping and Reporting. The Investment Advisers Act requires a registered investment adviser to maintain an extensive list of books and records. These books and records include accounting records and other documents, such as corporate records, certain written communications and reports and the records necessary to form the basis for or demonstrate the calculation of the performance or rate of return information used in offering materials. There are also specific record-keeping requirements in relation to compliance programs and the code of ethics. All books and records required to be

154. 17 C.F.R. § 275.206|4|-2.
155. 17 C.F.R. § 275.206|4|-2|b||3|.
156. 17 C.F.R. § 275.206|4|-1|b|.
157. 17 C.F.R. § 275.206|4|-1|a|1|.
158. 17 C.F.R. § 275.206|4|-1|a|2|.
159. 17 C.F.R. § 275.206|4|-1|a|5|.
160. 17 C.F.R. § 275.204-2|a|.
161. 17 C.F.R. § 275.204-2|a||17|.
162. 17 C.F.R. § 275.204-2|a||12|. 
retained under the Investment Advisers Act must be maintained in the adviser’s office for two years after the last entry date and in an easily accessible place for at least three additional years. Prior to registration, the adviser should review its record-keeping and document retention practices and policies to ensure compliance with the Investment Advisers Act, including what documents will be accessible in the event of an SEC inspection.

The Dodd-Frank Act imposes new record-keeping and reporting requirements on investment advisers to private equity funds registered with the SEC. Registered investment advisers will be required to maintain records and make all records available for SEC inspection. Such records must include a description for each fund of:

(i) side arrangements or side letters;
(ii) trading and investment positions;
(iii) the amount of assets under management and the use of leverage, including off-balance-sheet leverage;
(iv) counterparty credit risk exposures;
(v) trading practices;
(vi) valuation policies and practices;
(vii) the types of assets held; and
(viii) other information determined by the SEC and systemic risk regulators to be necessary and appropriate in the public interest and for the protection of investors or for the assessment of systemic risk.

The Dodd-Frank Act permits the SEC to modify examination and registration procedures for mid-sized private funds, but does not define this term or require the SEC to define this term. Under the Dodd-Frank Act, the SEC is also required to issue rules to require advisers to private equity funds to file reports with the SEC. Pursuant to this mandate, the SEC and the Commodity Futures Trading Commission have adopted a new rule requiring registered advisers advising one or more private funds that have at least $150 million in private fund regulatory assets under management to confidentially file Form PF with the SEC. Under the rule, all registered investment advisers will be required to file basic information about their private funds annually, and “Large Private Fund Advisers” will be required to report additional information either quarterly (for hedge fund advisers and liquidity

163. 17 C.F.R. § 275.204-2[c].
164. Dodd-Frank Act, tit. IV, § 404.
165. Dodd-Frank Act, tit. IV, § 408.
Large Private Fund Advisers are defined differently for different types of funds, but for advisers to private equity funds the threshold would be advisers that manage private equity funds that collectively have at least $2 billion in assets (including commitments) on the last day of the adviser’s most recently completed fiscal year. All registered advisers to private funds would have to provide certain general information, such as total and net assets under management, and other information about each private fund advised, including gross and net assets, fund borrowings, the fund’s investor base, and quarterly and monthly performance information. Large Private Fund Advisers to private equity funds would be required to provide additional information about each fund, including certain detailed information about the fund’s borrowings and guarantees, use of bridge financing, investments in financial institutions and the leverage at portfolio companies.\textsuperscript{166}

\textit{Antifraud.} Note that all investment advisers, whether registered or unregistered, are subject to the general antifraud provisions of section 206 of the Investment Advisers Act. In addition to the general anti-fraud rules under the Investment Advisers Act, Rule 206(4)-8 specifically prohibits an investment adviser to a pooled investment vehicle, including an unregistered adviser to a private equity fund, from making any false or misleading statement or omission of a material fact to any investor or prospective investor in the pooled investment vehicle, or to otherwise engage in any act, practice, or course of business, that is fraudulent, deceptive or manipulative with respect to any investor or prospective investor in the pooled investment vehicle. The rule is not limited to fraud in connection with the purchase or sale of securities. Accordingly, routine statements made by the investment adviser, such as quarterly reports to investors, are subject to the rule. The SEC does not need to prove that an investment adviser acted with scienter (that is, with the intent to deceive, manipulate, or defraud) under the rule.

\textit{State regulation.} State regulation of investment advisers and the location of the adviser for purposes of determining which state would have jurisdiction must also be considered. Although states are precluded from requiring the registration of advisers that are registered with the SEC,\textsuperscript{167} advisers relying on exemptions from registration under the Investment Advisers Act are not necessarily exempt from state registration requirements and the Dodd-Frank Act has increased

\textsuperscript{166} See Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Release No. IA-3308 (Oct. 31, 2011) (adopting Rule 204(b)-1 under the Investment Advisers Act of 1940).

\textsuperscript{167} IAA § 203A(b)(1).
the number of advisers that will be required to register with the states rather than the SEC.

§ 47:7.3 Carried Interest Exemptions

In order to receive its carried interest, a private equity fund adviser registered with the SEC will need to qualify for an exemption to the Investment Advisers Act restrictions on performance fees.

[A] Qualified Purchaser Funds

The most important exemption for registered private equity fund managers is the “qualified purchaser fund” exemption. Under this exemption, an investment advisory contract between an investment adviser and a fund that is exempt under section 3(c)(7) of the ICA is exempt from the carried interest prohibitions.\(^\text{168}\)

[B] Rule 205-3: “Qualified Client” Exemption

Rule 205-3 under the Investment Advisers Act allows an investment adviser to receive a “share of the capital gains upon, or the capital appreciation of, the funds of a client” if the client is a “qualified client.” Rules mandating the structure of the performance fee were eliminated in 1998 and the investment adviser and its qualified clients are now free to structure the terms of the fee.\(^\text{169}\) Although there are no longer specific disclosure requirements with respect to such fee arrangements, this does not obviate the need for the adviser, as a fiduciary, to provide its clients with full and fair disclosure of the adviser’s compensation arrangements.\(^\text{170}\)

For private equity funds which rely on the exemption provided by section 3(c)(1) of the ICA, each equity owner of the fund is considered to be a client for purposes of Rule 205-3. A client will be a “qualified client” if it has at least $1 million invested under the management of the investment adviser or has at least $2 million of net worth (excluding the value of the primary residence, and certain indebtedness secured by the primary residence).\(^\text{171}\) In addition, persons who meet the requirements to be a “qualified purchaser” and certain “knowledgeable employees” are also defined to be “qualified clients.” Equity

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168. IAA § 205(b)(4).
170. See id. at text surrounding nn.13 and 14.
171. These thresholds, which became effective May 22, 2012, replace the previous thresholds of $750,000 and $1.5 million, respectively. See Investment Adviser Performance Compensation, Investment Advisers Act Release No. IA-3372 (Feb. 15, 2012). The treatment of primary residences is analogous
owners that are not charged a performance fee are not required to be qualified clients. Finally, if an entity investing in a section 3(c)(1) fund is itself a section 3(c)(1) fund, each of the equity owners of the investing section 3(c)(1) fund (or of any additional tiered section 3(c)(1) funds) must meet the financial requirements of the "qualified client" rule. The rule also provides grandfathering rules for existing investors that would not meet any increased thresholds.

Advisers that are precluded from federal registration under section 203A of the Investment Advisers Act (which delineates federal and state regulation of investment advisers) are not automatically exempt from the carried interest prohibition, and therefore will need to separately qualify for a carried interest exemption.

§ 47:8 Additional Regulations

Private equity funds and fund managers also are or may be included within the definition of "financial institutions" under other regulatory schemes, and therefore are or may become subject to regulations that apply to such financial institutions, including privacy rules and anti-money laundering (AML) rules. "Pay-to-play" regulations may impose restrictions on advisers who solicit or advise government entities. The EU AIFM Directive which is in the process of being adopted in Europe may impose more stringent regulation on funds seeking capital in overseas markets.

§ 47:8.1 Gramm-Leach-Bliley Act Privacy Rule

Pursuant to the Gramm-Leach-Bliley Act,173 "financial institutions" subject to the Act include those that engage in financial activities described in the Bank Holding Company Act of 1956.174 The activities of private funds and fund managers fall within that definition. The Federal Trade Commission (FTC) has adopted rules (the "Privacy Rule") governing the disclosure of consumer financial information by financial institutions that are not subject to other regulation, which therefore includes investment advisers not

to the recent changes to the definition of net worth under the accredited investor definition in Regulation D of the Securities Act. See supra note 58. Under the Dodd-Frank Act, the SEC is required to adjust the qualified client threshold for inflation every five years.


registered with the SEC and private equity funds. SEC-registered investment advisers are subject to similar rules promulgated by the SEC.

The Privacy Rule requires that the financial institution: (i) notify all “customers” of its policies regarding disclosure of “nonpublic personal information” relating to such persons; and (ii) except as otherwise permitted by the rule, not disclose nonpublic personal information to unaffiliated third parties unless “consumers” have been provided with a reasonable opportunity to “opt out” from such disclosures. The notice to customers must be delivered at the time a customer relationship is established, and on an annual basis thereafter. The FTC and the SEC have each adopted a form of notice that can be used to comply with the notification requirements.

A “consumer” is any natural person who obtains a financial product or service from a financial institution that is to be used primarily for personal, family or household purposes. A “customer” is any consumer who has a continuing relationship with the financial institution. Any individual who provides nonpublic personal information in connection with a possible investment in a private investment fund would be a consumer of such fund, whether or not such investment is actually made, and any individual investor in a private investment fund would be a consumer and a customer of such fund. An investment manager whose only clients are funds would not be obligated to comply with the Privacy Rule.

176. “Nonpublic personal information” means: (i) any personally identifiable financial information (which includes any information not otherwise publicly available) which a consumer provides in furtherance of obtaining a financial product or service; and (ii) any list, description or other grouping of consumers that is derived using any such personally identifiable financial information. Therefore, nonpublic personal information would include any nonpublic personal information provided by an investor in a private investment fund, or a potential investor, and any list of such investors or potential investors. Information is public if you have a reasonable basis to believe it is lawfully made available to the general public from government records, widely distributed media (e.g., a telephone book, newspaper, website), or disclosures to the general public required to be made by law. 16 C.F.R. § 313.3[n] and [p].
177. Typically this initial privacy notice is distributed as a part of the fund’s subscription documents.
178. A notice must be provided to a consumer who is not a customer only if and when the financial institution discloses nonpublic personal information to a nonaffiliated third party, other than pursuant to an exception to the Privacy Rule.
The Privacy Rule allows for disclosure of nonpublic personal information to nonaffiliated third parties under certain circumstances without the requirement of allowing consumers to opt out of such disclosures. These exemptions facilitate the ordinary conduct of business by permitting disclosure to:

(i) nonaffiliated third parties that perform services for the financial institution, such as marketing services, pursuant to an agreement with the financial institution;

(ii) as necessary to effect a transaction that a consumer authorizes;

(iii) with the consent of the consumer, such as pursuant to an agreement with the customer;

(iv) fiduciaries or agents of the financial institution, such as attorneys, accountants, rating agencies; and

(v) regulators.

These exemptions should cover disclosure of the identity of fund investors, their address and capital contributions (which is typically included on a schedule to the partnership agreement or LLC agreement) to other investors pursuant to the terms of a fund’s partnership agreement or LLC agreement, or pursuant to applicable partnership or LLC law. Disclosure of nonpublic personal information concerning fund investors made to other financial institutions to facilitate a fund’s portfolio transactions, for example, to a lender with respect to obtaining a credit facility, or to permit the distribution in kind of a portfolio company’s securities, should also be covered by the above exemptions, as being necessary to effect or administer a transaction authorized by a consumer. However, it is necessary to review the particular operating agreement and business practices to determine whether and how these exemptions apply to a particular fund.

The exemptions permit the disclosure of information without giving the consumer the ability to opt out of such disclosures. However, they do not provide an exemption from the notice requirement. Consequently, every private equity fund must provide the required notice of its privacy policies to each natural person that invests in the fund.

§ 47:8.2 Gramm-Leach-Bliley Act Safeguards Rule

The Gramm-Leach-Bliley Act also requires financial institutions to take steps to ensure the security and confidentiality of customer...
The FTC has issued a rule (the “Safeguards Rule”) that requires each financial institution subject to its jurisdiction under Gramm-Leach-Bliley to develop and implement a safeguards program designed to protect customer information. The Safeguards Rule covers financial institutions that collect nonpublic personal information from their customers, and also those that receive customer information from other financial institutions. Therefore, a nonregistered investment adviser that is not subject to the Privacy Rule because its only clients are one or more private equity funds would nonetheless be subject to the Safeguards Rule if it receives any information about natural persons who are investors in its funds. The Privacy Rule adopted by the SEC covering SEC-registered investment advisers also requires that those entities adopt policies and procedures that address the safeguarding of customer information.

A safeguards program adopted under the FTC Safeguards Rule must provide for:

(i) the designation of an employee responsible for coordinating the firm’s program;

(ii) an assessment of the risks to customer information in each area of the firm’s business;

(iii) the design and adoption of a written plan to control these risks and to monitor effectiveness;

(iv) if service providers have access to customer information, the implementation of appropriate measures to ensure the safety of such information, such as contractual provisions; and

(v) the evaluation and revision of the program as a result of changes to business operations and other changed circumstances.

Firms must pay special attention to three areas of risk:

180. The definition of “customer,” as well as the definitions of other terms used in both the Privacy Rule and the Safeguards Rule, is incorporated from the Privacy Rule.
182. SEC-registered investment advisers are subject to the Safeguards Rule promulgated by the SEC in Regulation S-P, Release No. 34-42974 (June 29, 2000, effective as of Nov. 13, 2000). 17 C.F.R. § 248.30, adopted by Regulation S-P, requires every SEC-registered investment adviser to adopt policies and procedures that address administrative, technical and physical safeguards for the protection of customer records and information.
Each financial institution must establish a program appropriate for its size, the nature, scope and complexity of its operations, and the sensitivity of the customer information that it maintains.

§ 47:8.3 PATRIOT Act Anti-Money Laundering Programs

The International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 (the “IMLA Act”), which comprises Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “USA PATRIOT Act”), signed into law on October 26, 2001, adopted international counter-money laundering and related measures and amended the anti-money laundering record-keeping and reporting provisions of the Bank Secrecy Act (BSA). Various provisions of the IMLA Act apply to “financial institutions” as defined in the BSA, which include private equity funds. Although fund managers were not originally included within the BSA definition, in May 2003, the Secretary of the Treasury, under powers granted by the BSA, proposed to define SEC-registered investment advisers and advisers relying on the private adviser exemption as financial institutions for purposes of certain anti-money laundering provisions. On October 30, 2008, the Financial Crimes Enforcement Network (FinCEN) of the Treasury Department announced the withdrawal of the proposed anti-money laundering rules for investment advisers, citing the “passage of time” as the primary reason for withdrawing the proposed rules.

The IMLA Act required each financial institution to establish an internal anti-money laundering program by April 24, 2002. On April 23, 2002, the Treasury Department exercised its authority to postpone the application of the IMLA Act for private funds, and, in September 2002, issued proposed rules for such funds. However, on


184. 31 U.S.C. § 5312(a)[2].


October 30, 2008, FinCEN announced the withdrawal of the proposed anti-money laundering rules for private funds as well.

Whether or not Treasury rules affecting private equity funds are ever adopted, private equity funds are subject to U.S. laws and regulations prohibiting doing business with certain countries and persons, such as those included on the Specially Designated Nationals list maintained by the Treasury’s Office of Foreign Assets Control (OFAC). Private equity funds also remain subject to U.S. criminal laws that prohibit knowing involvement in transactions involving the proceeds of unlawful activity and to BSA requirements for reporting certain cash or cash-equivalent transactions and the existence of bank or financial accounts located in a foreign country. In addition, funds are increasingly being asked to make representations regarding their investors, the sources of such investors’ funds and similar matters by brokers and others with whom the fund does business who are themselves subject to anti-money laundering regulations both in the United States and abroad. In order to comply with existing law and to be able to make these representations, private equity funds have generally adopted practices with respect to checking investors against the OFAC and similar lists and other procedures relating to investor identity.

§ 47:8.4 “Pay-to-Play” and Placement Agent Regulations

State and local public pension funds constitute a significant class of private equity investors. In part arising out of scandals in the municipal securities market, many states and localities have adopted so-called “pay-to-play” laws that prohibit, restrict, or require disclosure of payments to public officials by individuals and entities seeking to do business with state or local entities, including investments by public-employee retirement funds, or that restrict the use of third-party placement agents. In addition, some pension funds and other government entities impose disclosure requirements or other restrictions on advisers seeking to manage the pension fund or government entity’s assets.

In the wake of the 2009 indictments of, and SEC civil action against, a former chief investment officer of the New York State Common Retirement Fund (NYSCRF) and the senior political advisor to the former fiduciary of the pension fund for, among other things, soliciting improper placement fees and other payments, NYSCRF banned the use of placement agents entirely by sponsors of private

187. For the current list and information regarding such restrictions, see www.treas.gov/offices/enforcement/ofac/.
188. See 31 C.F.R. § 103.
equity funds.\textsuperscript{189} New York City imposed a ban on the use of placement agents by investment managers of private equity funds seeking to do business with the city’s pension funds, and investment managers must certify that no gifts were given to pension fund officials.\textsuperscript{190} In addition, persons soliciting the New York City pension funds, whether third-party placement agents or in-house personnel, are also subject to the New York City lobbying law, which may require registration and prohibits the payment of a “success fee” to placement agents with respect to New York City fund-related activities.\textsuperscript{191}

In 2009, California adopted legislation requiring state and local pension systems to adopt policies requiring disclosure by those who use placement agents to solicit investments by those systems.\textsuperscript{192} In 2010, California went further and enacted legislation that defines a placement agent, including certain employees of fund sponsors, to be a lobbyist under state and local lobbying laws thus triggering registration, disclosure and various other requirements at the state level with respect to soliciting state pension systems, such as CalPERS and CalSTRS.\textsuperscript{193} Similar to New York City lobbying law, registered lobbyists in California may not be paid a fee that is contingent upon the investment decisions of a state plan. In addition, many municipalities in California have their own lobbying laws, potentially requiring registration and compliance with other requirements for soliciting local pension funds, depending on the local law.


In June 2010, the SEC issued a rule, effective September 13, 2010, that prohibits an investment adviser, whether registered or unregistered in reliance on the exemption under former section 203(b)(3) of the Investment Advisers Act, from receiving compensation for providing advisory services to a government client for two years after the adviser or certain of its executives or employees makes a political contribution to elected officials or candidates in a position to influence the selection of advisers. 194 Compliance with the political contribution provisions was required beginning on March 14, 2011. In light of adoption of the Dodd-Frank Act, the SEC has amended the rule to cover SEC-registered investment advisers, exempt reporting advisers (that is, advisers relying on the venture capital adviser exemption or the private fund adviser exemption), and advisers relying on the foreign private adviser exemption. 195 The rule also prohibits an adviser itself or certain executives and employees from soliciting or coordinating certain contributions from others. It also prohibits solicitation and coordination of payments to political parties in the state or locality where the adviser is seeking business. The two-year ban would follow an employee who was promoted to a position subject to the rule, although an employee moving to a new adviser would generally only be subject to a six-month “look-back.” The rule includes only limited exceptions. 196

As originally proposed, the SEC rule would have flatly banned advisers from using placement agents, or other third parties, directly or indirectly, to solicit advisory business from government entities, including for investment into certain pooled investment vehicles, including private equity funds. 197 This proposed ban encountered extensive opposition, and as adopted the SEC rule permits the use of placement agents provided the agent is an SEC-registered investment adviser (subject to certain limitations) or an SEC-registered broker-dealer that is a member of a national securities association that the SEC determines to have pay-to-play restrictions substantially equivalent to the SEC rule. 198 The SEC has added registered municipal advisers to the category of potentially acceptable placement agents

196. The rule contains a de minimis exception, whereby an executive or employee covered by the rule may make contributions of up to $350 per election per candidate if the contributor is entitled to vote for the candidate, and up to $150 per election per candidate if the contributor is not entitled to vote for the candidate.
and has extended the date by which advisers must comply with the placement agent restrictions to nine months after the compliance date of a final rule to be adopted by the SEC pursuant to which municipal advisors must register under the Exchange Act in order to give FINRA and the Municipal Securities Rulemaking Board a sufficient opportunity to adopt the necessary pay-to-play restrictions.199

To avoid possible circumvention, the rule makes it unlawful for an adviser or any of its covered associates to do anything indirectly that, if done directly, would violate the rule.

In light of the wide scope and variety of regulation in this area at state, local and pension fund levels, fund managers should exercise diligence before directly or indirectly soliciting business from public pension plans and other government-affiliated investment pools, and should carefully monitor future developments with respect to political contributions and use of placement agents.

§ 47:8.5 EU AIFM Directive


For EU-based managers, the Directive contemplates a “passport” system to enable managers authorized in any EU member state to market and manage EU-based funds anywhere in the EU under a pan-European regulatory system by 2013. U.S. fund managers are expected to be able to participate in the passport system after a two-year transition period, but subject to complying with most of the substantive requirements imposed on EU managers. Following that


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transition period, U.S. managers would operate under a “dual” system giving them the ability to either follow the private placement regime of each applicable EU member state, or utilize the passport system. Eventually, once adopted by all EU member states, the passport system is intended to be the sole system governing the marketing or managing of alternative investment funds within the EU, making compliance with many aspects of the Directive (including disclosure requirements and restrictions on management compensation) mandatory for any U.S. fund manager seeking to market or manage alternative investment funds in Europe.

§ 47:8.6 Foreign Corrupt Practices Act

Regulators and policymakers have dramatically increased their focus on bribery and corruption by multi-national businesses in recent years, both in the United States and abroad. The Foreign Corrupt Practices Act of 1977, as amended (FCPA),\(^2\) the core U.S. anti-corruption legislation, may create potential liability for private equity firms stemming from the actions of employees and agents, associated with the pre-acquisition activities of the firm’s portfolio companies and parent liability stemming from the post-acquisition activities of the firm’s portfolio companies. Private equity firms should assess the firm’s risk based on its business operations, and should address in its policies and procedures actions by firm employees, use of foreign placement agents, and pre-acquisition and ongoing diligence of portfolio companies.

The “anti-bribery provisions” of the FCPA prohibit any corrupt payment or offer to a foreign official for the purpose of obtaining or retaining business for or with, or directing business to, any person. The FCPA applies to a wide range of persons, including registered issuers, private business entities organized in the United States, any of their officers, directors, employees, or shareholders acting on their behalf, and U.S. citizens or residents. Prohibited payments are broadly defined to include not only cash bribes, but also non-monetary contributions, gifts, entertainment, and travel.

Even payments to a third party while knowing that some portion of those payments will be offered or given to a foreign official are unlawful. A parent company can be liable for acts of bribery at a subsidiary company that are authorized, directed, or controlled by the parent, or where it has awareness of a high probability of an improper payment and takes no steps to stop the corrupt payments.

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§ 47:9 Change in Control of Fund Sponsors

In recent years, there have been a number of transactions involving the purchase and sale of a fund sponsor’s business. When such transaction involves a sale of a registered adviser’s funds or a sale of all or part of the adviser, the transaction may be considered an “assignment” under the Investment Advisers Act thereby requiring the approval of the fund and/or the fund investors. “Assignment” is defined as including any transfer of an investment advisory contract by the assignor or of a controlling block of the assignor’s outstanding voting securities by a security holder of the assignor. 203 A broad inquiry of all facts and circumstances must be undertaken in determining whether a controlling block is being transferred for purposes of determining whether the transaction constitutes an “assignment” under the Investment Advisers Act. Where such a transaction would result in a change of actual control or management of a fund adviser, the SEC 204 and the staff 205 have taken the position that if the adviser notifies a client in writing of an assignment and informs the client that the assignment will take place, if the client does not object within a reasonable period of time, the client’s silence may be treated as appropriate consent. However, if the form of investment management agreement expressly provides that the agreement may not be assigned without the prior written consent of the other party, such negative consent may not suffice. Determining who can consent on behalf of a fund (the client) can be complicated and will require careful assessment of the fund documentation.

203. Investment Advisers Act § 202(a)(1). “Controlling block” is not defined, but “control” is defined as the power to exercise a controlling influence over the management or policies of a company unless such power is solely the result of an official position with such company, IAA § 205(a)(12). “Controlling influence” is not defined in the IAA. The SEC has stated that controlling influence means something less than the absolute and complete domination of a company and may be the result of “historical, traditional or contractual associations of persons with companies or a dominating persuasiveness of one of more persons acting in concert or alone.” Investors Mutual, Inc., ICA Rel. No. 4595, 1966 SEC LEXIS 901 [May 11, 1966], aff’d, Phillips v. SEC, 388 F.2d 964 [2d Cir. 1968]. The SEC cites Detroit Edison Co. v. SEC, 119 F.2d 730 [6th Cir.], cert. denied, 314 U.S. 618 [1941], under the Public Utility Holding Company Act, and states that the interpretations of “controlling influence” under that Act are entitled to substantial weight in construing section 2(a)(9) of the ICA.

204. See Item 5 of Form ADV-W, which states that client consent may be inferred from negative consent.