COMPLIANCE CORNER

Certain Considerations for Establishing a Private Fund

By Robert B. Van Grover, Esq., Seward & Kissel LLP*

INTRODUCTION

Private funds are pooled investment vehicles formed in the United States ("domestic funds") or in foreign tax haven jurisdictions ("offshore funds") offered on a private basis to certain qualified clients. Domestic funds are generally organized as limited partnerships or limited liability companies, while offshore funds are generally organized as limited liability companies or limited partnerships. Regulatory requirements for private funds are substantially less burdensome than for public or mutual funds – and they are consequently less expensive to run. Private funds give investment advisers the opportunity to manage client assets through a pooled vehicle, permitting the manager to accept and manage, if desired, smaller amounts than would be feasible in a separate account in a more cost-effective manner. New strategies can also be incubated in private funds for clients who want limited exposure to those strategies. Private funds also offer the investment adviser the ability to create accounts with terms that allow the adviser greater stability in its asset base by limiting the timing of withdrawals by investors, thereby granting the adviser greater freedom to explore investment strategies that may have longer-term horizons.

This article will explore some of the various legal and regulatory considerations arising from setting up and operating a private fund that invests in securities, as well as compliance considerations.

Robert B. Van Grover
Partner
Seward & Kissel LLP

"It is important to note that in determining whether a public offering exists, it is the total number of offerees and not the number of ultimate purchasers that is taken into account."

LEGAL ISSUES AFFECTING PRIVATE FUNDS

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

Federal Securities Laws

A. Securities Act of 1933

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

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

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

Continued on page 18

Continued from page 17

ner of offering (including information to be supplied to purchasers) and the nature of purchasers.

- **Manner of Offering.** Under Rule 506(b) (which is the most commonly relied upon "safe harbor" for private funds), neither the private fund nor any person acting on its behalf may offer to sell or sell interests in the private fund through any general solicitation or general advertising (such as a newspaper article or advertisement, a seminar, or any circular that is distributed to the public). Brokers should not send private fund offering material to any investor with whom they do not already have a substantive pre-existing business relationship. Similarly, the manager should not send offering materials to investors with whom the manager or its officers or shareholders are not personally or professionally acquainted. An offering memorandum should be prepared and used in connection with the solicitation of investors. Under Rule 506(c), an issuer may conduct a private placement of securities under Rule 506 while engaging in general solicitation or general advertising in offering and selling securities provided that: (i) the offering complies with the other general requirements for a Regulation D private placement, which are set forth in Rule 501 and 502; (ii) all purchasers of the securities are Accredited Investors (which are generally individuals with a net worth of $1 million or more and entities with total assets of $5 million or more); and (iii) the issuer takes reasonable steps to verify that such purchasers are Accredited Investors. Finally, the SEC also added an informational item to Form D for issuers to indicate when they are relying on Rule 506(c). Under Rule 506 of Regulation D an issuer may offer and sell to a potentially unlimited number of Accredited Investors and up to 35 other sophisticated purchasers.

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

- **Nature of Purchasers: Accredited and Non-Accredited Investors; Net Worth Requirements.** Rule 506(b) limits the number of sales of private fund interests that may be made to non-accredited sophisticated investors to a total of 35. There is no limit under Rule 506 on the number of sales which may be made to "Accredited Investors" (although, as discussed below, other federal securities law provisions provide other limitations on the total number of beneficial owners of private fund interests in a private fund).
- **Bad Actor Disqualification.** The private offering safe harbor under Regulation D will not be available to an issuer who has had certain disqualifying events that make it a "bad actor" under Rule 506(d) of the Securities Act. Under the "bad actor" disqualification provisions of Rule 506(d) of the Securities Act, an issuer may not rely on the Rule 506 offering exemption if the issuer or certain other persons involved with the offering (including both placement agents and any beneficial owner of 20% or more of the issuer's outstanding voting equity securities) has a disqualifying event, unless the disqualification is waived or otherwise remedied. Events occurring prior to September 23, 2013 that would be disqualifying events if they had occurred after such date will not disqualify an issuer from relying on Rule 506, but must be disclosed in writing to offerees a reasonable time prior to sale. An issuer that is disqualified from relying on Rule 506 may, under certain circumstances, privately offer securities, but will be required to rely on more limited and burdensome exemptions from registration.[1] Any issuer that made sales at a time when there were unknown disqualifying events may still rely on Rule 506 for those prior sales, if the issuer can establish that it did not know and, in the exercise of reasonable care, could not have known that such disqualifying events existed.
- **Disclosure Requirements.** Even though Regulation D does not contain specific disclosure requirements if securities of a private fund are sold only to Accredited Investors, the anti-fraud provisions of the U.S. securities laws still apply. Care must be taken to ensure that the disclosures made to investors include all material facts and do not contain any materially false or misleading statements. If securities are sold to persons who are not Accredited Investors, disclosure materials must conform to certain standards that are generally equivalent to those governing disclosures in registered offerings in the U.S.
- **Resale Restrictions.** Securities acquired in a Regulation D (and Section 4(a)(2)) private placement in the U.S. are "restricted securities" – they may not be resold by the investor, other than pursuant to registration under the Securities Act or pursuant to exemption from such registration.
- **Filing Requirements.** Private funds selling securities in reliance on Regulation D are required to file a notice on Form D with the SEC no later than 15 days after the first sale of securities. Thereafter, they must correct any material mistakes and certain other changes to the information on an ongoing basis, and must file an updated Form D on an annual basis

Continued on page 19

so long as the offering is continuing (*i.e.,* as long as the fund is still open to or accepting new investors).

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

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

Regulation as a "broker" or "dealer" of the private fund and as an "agent" or "salesman" of the adviser, or another person making an offering on behalf of the private fund, may also be imposed by some states.

5. Foreign Laws. Private funds must also comply with the relevant laws of each non-U.S. jurisdiction in which their interests are offered and sold. Many non-U.S. jurisdictions have exemptions similar to the Securities Act's private offering or Regulation D exemption but, even in those jurisdictions, care must be taken to ensure that appropriate filings are made and any applicable disclaimers or legends are included in the private fund's offering documents, as required in the jurisdiction.

B. Securities Exchange Act of 1934

1. Exemptions from Broker-Dealer Registration.

- **Issuer Exemption.** The Securities Exchange Act of 1934 (the "Exchange Act") requires the registration of securities brokers and dealers. A "broker" under the Exchange Act is "any person engaged in the business of effecting transactions in securities for the account of others." Generally, a private fund trades for its own account and not for the accounts of others, and therefore would not be required to register as a "broker" under the Exchange Act. A "dealer" under the Exchange Act is "any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise." Most private funds however are entities that trade securities solely for their own investment account and without carrying on a public securities business, thus private funds are generally excepted from registration as a "dealer" under the Exchange Act as well.
- **Agent Exemption.** Officers or directors of the private fund, owners or employees of the investment manager to the private fund, and independent solicitors who place securities of the private fund may be subject to registration in the U.S. as brokers. This can be the case even if no sales load is charged to investors. Using a registered broker-dealer as a placement agent is one way for a sponsoring investment adviser and its employees to avoid broker-dealer registration. Rule 3a4-1 under the Exchange Act deems certain "associated persons" of an issuer of securities not to be brokers, subject to certain conditions. Associated persons relying on this exemption, among other conditions, cannot be subject to statutory disqualification (for certain prior bad acts), cannot be compensated by the payment of commissions or other remuneration based directly or indirectly on transactions in securities, and cannot be an associated person of any broker or dealer.

2. Exchange Act Issuer Registration.

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

C. Investment Company Act of 1940

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

In order for a private fund not to

Continued on page 20

Continued from page 19

be considered an "investment company" under the Investment Company Act, the private fund will usually satisfy the requirements of either Section 3(c)(1) of the Investment Company Act (the "Limited Investor" exemption) or Section 3(c)(7) of the Investment Company Act (the "qualified purchaser fund" exemption).

1. 3(c)(1) Funds.

To qualify under the "Limited Investor" exemption:

(i) Interests in the private fund (which constitute "securities" for purposes of the federal securities laws) may not at any time be owned beneficially by more than 100 persons (or, in the case of a qualifying venture capital fund, 250) within the meaning of Section 3(c)(1) of the Investment Company Act;[2] and

(ii) The private fund may not engage in a public offering of the securities within the meaning of the Securities Act (see discussion above).

2. 3(c)(7) Funds.

To qualify under the "qualified purchaser fund" exemption:

(i) Interests in the private fund must be owned only by "qualified purchasers" within the meaning of Section 3(c)(7) of the Investment Company Act (generally individuals and family owned companies that own "Investments" [see "Determination of 'Investments'" below] of at least $5,000,000 or entities (other than family-owned companies) that own "Investments" of at least $25,000,000); and

(ii) The private fund may not engage in a public offering of its securities within the meaning of the Securities Act (see discussion above).

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

Determination of "Investments"

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

1. Investments include the following:

(A) securities that are publicly-traded and listed on a U.S. national securities exchange or traded on NASDAQ;

(B) shares in registered investment companies such as mutual funds and money market funds;

(C) interests in private investment companies such as hedge funds, commodity pools, and similar private investment companies;

(D) cash and cash equivalents (including foreign currencies) held for investment purposes;

(E) real estate held for investment purposes;

(F) shares of non-public companies that have total shareholder equity of $50 million or more;

(G) commodity interests, including commodity futures contracts and options thereon, swaps, and other financial contracts.

2. Investments **DO NOT** include the following:

(A) jewelry, artwork, antiques and collectibles;

(B) investments held in retirement accounts for which the investor does not make the investment decisions (*e.g.,* an employer retirement plan the investment decisions of which are not directed by the investor);

(C) shares in a non-public company in which the investor has a controlling interest (presumed to exist if the investor owns more than 25% of the voting interests).

COMPLIANCE CONSIDERATIONS

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

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

- Does the private fund have a different fee structure than the adviser's managed accounts? Different fee structures may create a conflict for the adviser, which weighs in favor of the adviser providing a heightened review of comparative performance and investment allocations.
- Are the adviser's custody procedures sufficient given the fact that the adviser, by virtue of being (or having a related person be) the general partner of a private fund, will be considered to have "custody" of client assets within the meaning of Advisers Act Rule 206(4)-2? Does the capitalization or composition of the board of the offshore fund result in the adviser being deemed to have custody of client assets?
- Do the private fund's offering documents conform to the adviser's actual management of the private fund and are they consistent with disclosures made in the adviser's other documents (*e.g.,* the adviser's Form ADV and marketing material)? Is that documentation updated accordingly to reflect material changes?

Continued on page 21

- Has the adviser's Form ADV been revised to reflect the management of the private fund (including Item 7 and Section 7 of Schedule D)? Is the adviser required to complete and file SEC Form PF (for reporting information on private funds when a registered investment adviser has at least $150 million in regulatory assets under management attributable to private funds)?

CONCLUSION

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

**Robert B. Van Grover, Esq. is a Partner in the Investment Management Group at the New York law firm of Seward & Kissel LLP. Mr. Van Grover concentrates his practice in the area of investment management, including private investment funds (U.S. and offshore hedge funds, funds of funds, private equity funds, commodity pools and group trusts), managed accounts, investment adviser regulatory compliance (including mock audits), and related investment management matters. He has written and spoken extensively in the investment management area. Mr. Van Grover can be reached by telephone at (212) 574-1205 or by e-mail at vangrover@sewkis.com. The firm maintains relevant materials about hedge funds and investment management matters on its website, sewkis.com.*

This article is intended to provide general information on the matters discussed. It should not be relied upon for legal, regulatory or tax advice on any matter. IAA

[1]The limited exemptions include Rule 504 and Rule 505. Rule 504 and Rule 505 limit the amount of securities that may be offered to $1 million and $5 million respectively. Seeking these alternative exemptions on a state-by-state basis can be burdensome in terms of time and expense. These alternative offerings will also involve making significant additional filings on a state-by-state basis. Depending on the terms of the offering, some issuers may not be able to comply with certain states' rules and would therefore not be able to offer or sell their securities in that state.

[2] The term "qualifying venture capital fund" means a venture capital fund (as defined in the rules promulgated under the Advisers Act) that has not more than $10 million (indexed for inflation) in aggregate capital contributions and uncalled committed capital.

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

[3] 15 U.S.C. § 80a-3(c)(7)(E).