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U.S. REGULATION OF PRIVATE INVESTMENT FUNDS

Private Investment Vehicles Must Operate Within a Web of Rules Imposed by a Complex of Statutes and Regulations, from the Securities Act of 1933 to the USA PATRIOT Act of 2001. The Author Outlines the Requirements Governing Such Matters as Exemptions from Registration, Portfolio Disclosures, and Anti-Money Laundering Programs.

By Steven B. Nadel*

This article presents a general overview of the principal U.S. regulatory requirements that are applicable to private investment funds and their managers.

INVESTMENT COMPANY ACT OF 1940

Private investment funds are not subject to U.S. Securities and Exchange Commission ("SEC") registration as mutual funds, because they rely on one of the two exemptions from such registration found in Sections 3(c)(1) and 3(c)(7) of the U.S. Investment Company Act of 1940 (the "1940 Act").

Section 3(c)(1)

A privately offered fund (see discussion below relating to private placements under the "Securities Act of 1933") that has no more than 100 beneficial owners (generally, in the case of non-U.S. funds, only U.S. beneficial owners need to be counted) is not required to register as an investment company under Section 3(c)(1) of the 1940 Act (and is referred to as a "3(c)(1) fund"). In a 3(c)(1) fund, when counting beneficial owners, there will be a look-through to: (i) the underlying investors of any fund-of-funds, other passive investment vehicle relying upon Section 3(c)(1) or Section 3(c)(7) (discussed below) or registered investment company owning 10% or more of the 3(c)(1) fund, (ii) those participants of any self-directed pension plan that have individually elected to have their plan monies invested in the 3(c)(1) fund, and (iii) the owners of any entity formed for the purpose of investing in the 3(c)(1) fund (i.e., if 40% or more of the entity's assets are invested in the 3(c)(1) fund). There may also be an "integration" of the beneficial owners of other 3(c)(1) funds that have similar investment objectives. Note that a husband and wife who are investing jointly in a 3(c)(1) fund will only count as one investor, as will a person who invests in his individual capacity and through an IRA.

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Section 3(c)(7)

A privately offered fund in which each investor is a qualified purchaser (generally, an individual with $5 million or more in "investments" or an entity with $25 million or more in "investments") is exempt from registration as an investment company under Section 3(c)(7) of the 1940 Act (and is referred to as a "3(c)(7) fund"). "Investments" is broadly defined by the SEC and includes securities, cash and cash equivalents, real estate held for investment purposes, and many other items; however, when calculating investments, any acquisition indebtedness must be deducted. While there is no explicit investor limitation in Section 3(c)(7) (such as the 100 beneficial owner limitation found in Section 3(c)(1)), in order for a 3(c)(7) fund to avoid being considered a "reporting company" under relevant U.S. securities laws, it should have no more than 499 investors.

Knowledgeable Employees

Certain persons who are executive officers of the fund or its manager or who participate in the investment activities of the fund are "knowledgeable employees" and need not be counted for purposes of the 100 beneficial owner limitation under Section 3(c)(1) and need not be "qualified purchasers" under Section 3(c)(7).

SECURITIES ACT OF 1933

As mentioned above, private investment fund interests must always be offered and sold on a private placement basis.

Generally, such an offering will be made pursuant to the "safe harbor" private placement requirements of Regulation D to prospective investors with whom there is a substantive pre-existing relationship. No form of general solicitation or advertising may be used, such as cold calls, use of the media, public interviews or password-free websites. Typically, the offering is made only to "accredited investors", which essentially means individuals that have at least a $1 million net worth and entities that have at least $5 million in total assets. Subject to other applicable legal requirements, the fund may also have up to 35 unaccredited investors, all of whom should be financially sophisticated.

Separately, Regulation S provides another exemption for the private placement of securities outside of the U.S. Under Regulation S, the offer and sale must be made to a person outside of the U.S. and the seller must not engage in any "directed selling efforts" in the U.S. Typically, Regulation S is relied upon in connection with the private placement of a non-U.S. fund to non-U.S. investors.

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INVESTMENT ADVISERS ACT OF 1940

Many private investment fund managers are exempt from registration as investment advisers with the SEC because they have fewer than 15 clients over a 12-month period and do not hold themselves out to the public as investment advisers (e.g., no advertisements in the yellow pages or newspapers, no password-free websites). For this purpose, a private investment fund generally counts as one client, as does each separately managed account.

If a private investment fund manager is registered as an investment adviser with the SEC, it will, among other things: (i) have to file and periodically amend a Form ADV, (ii) be subject to periodic SEC audits, (iii) be permitted to charge performance fees only to those clients who represent that they are "qualified clients" (generally, a $1.5 million net worth; however, in the case of a 3(c)(1) fund-of-funds or similar fund investing in the fund, each of the investing fund's investors must meet this criteria), and (iv) need to adopt various procedures and policies, including procedures relating to its custody of client funds, proxy voting and insider trading. As discussed in further detail below, individual states may require investment adviser registration, even if the manager is exempt from SEC registration.

COMMODITY EXCHANGE ACT AND NATIONAL FUTURES ASSOCIATION RULES

If a private investment fund utilizes any type of futures (including single stock futures), even if just for hedging or on a de minimis basis, U.S. Commodity Futures Trading Commission ("CFTC") registration of the fund's manager as a commodity pool operator and, possibly, commodity trading advisor may be required. The CFTC registration requirement would also apply to the managers of: (i) non-U.S. funds with a U.S. jurisdictional nexus (such as those funds with a U.S. manager, U.S. director(s) and/or U.S. investors), and (ii) funds-of-funds that invest in other funds that trade in futures. Forward contracts, swaps, certain synthetic derivatives developed by prime brokers and stock index options generally are not considered futures.

Among other things, CFTC registration usually requires the passage by certain management personnel of a Series 3 exam, unless the commodity trading is limited and done solely for hedging/risk management purposes, in which case a waiver from the examination requirement may be sought. CFTC registration also imposes various reporting, record-keeping and disclosure obligations, which may, to some degree, be mitigated, if the fund is able to rely on the exemptions provided by CFTC Rule 4.7 (i.e., all of the investors in the fund are "qualified eligible persons", which essentially means accredited investors with a $2 million securities portfolio) or Rule 4.12(b) (i.e., essentially, the fund limits its futures exposure to no greater than 10% commodity futures margin and premiums, but the fund's investors do not have to meet the Rule 4.7 criteria). A Rule 4.7 fund would not have to file a disclosure document with the CFTC, while a 4.12(b) fund would have to make such a filing, although there would be less disclosure required in a 4.12(b) fund's disclosure document than in a disclosure document for a fund that could not rely on Rule 4.12(b).

A manager may, however, seek registration relief if:

(i) it is a non-US manager trading only non-US futures;

(ii) the fund's participants are accredited investors, knowledgeable employees and certain family trusts formed by accredited investors and the manager claiming this exemption operates the fund such that it meets one of the following trading limitations (whether or not for hedging) at all times: (1) the aggregate initial margin and premiums required to establish commodity positions will not exceed 5% of the liquidation value of the fund's portfolio after taking into account unrealized profits and losses on any such positions (provided that with respect to an option that is in-the-money at the time of purchase, the in-the-money amount may be excluded in computing the 5%) or (2) the aggregate net notional value of such positions will not exceed 100% of the liquidation value of the fund's portfolio after taking into account unrealized profits and losses on any such positions;

(iii) (1) each fund participant that is a natural person is a "qualified purchaser" (generally, a person owning investments of not less than $5 million), knowledgeable employee (including principals of the manager) or a non-U.S. person and (2) each fund participant that is a non-natural person is either a "qualified eligible person" (generally, owning a securities portfolio of at least $2 mil-

lion), an accredited investor (generally, having assets in excess of $5 million) or a non-U.S. person or entity. There is no trading limitation under this exemption; or

(iv) in the case of a fund-of-funds manager, it can meet the requirements set forth in (ii) or (iii) above, noting that the CFTC has adopted Appendix A to Part 4 of its Rules illustrating how the trading limitations in (ii) above would apply to a fund-of-funds manager.

Also of relevance, U.S. National Futures Association ("NFA") Compliance Rule 2-38 requires all commodity pool operators and commodity trading advisors to establish a written contingency plan and to provide the NFA with emergency contact information.

EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 ("ERISA")

Most private investment fund managers (including non-U.S. funds) will limit the investment by benefit plan assets in the fund to less than 25% of the value of any class of securities within their funds. Benefit plan assets include assets of both U.S. and non-U.S. employee benefit plans, governmental plans, pension plans, 401k plans, 403b plans, Keogh plans, IRAs and entities that themselves have 25% or more benefit plan assets (e.g., group trusts). If a fund reaches the 25% threshold, there are many ERISA issues to contend with, including bonding, SEC registration of the manager as an investment adviser, custody matters, soft dollar restrictions, added liabilities and prohibited transaction rules. In certain cases, the fund may be able to exceed the 25% threshold without being subject to certain of the requirements set forth above, if, for example, the manager is a "qualified professional asset manager" or the fund is a "venture capital operating company".

PORTFOLIO DISCLOSURE REQUIREMENTS

There are currently a number of rules, regulations and interpretations requiring private investment fund managers to disclose certain fund holdings.

Securities Exchange Act

A Schedule 13G filing with the SEC, the issuer and the applicable exchange is generally required if a passive investment position of greater than 5% (but less than 20%) of the outstanding securities of a class of publicly-traded "equity" security registered under the Exchange Act is beneficially owned (looking at all accounts over which there is investment discretion). A Schedule 13D filing is generally required if the position size is 20% or greater, is between 5% and 20% and is not passive, or the person is a director or officer of the issuer (again, looking at all accounts over which there is investment discretion). 13G and 13D filings are required soon after the initial trigger is met and at various other times to reflect certain changes in status, however, 13G filings are not required as frequently and are not as extensive as 13D filings. The manager and certain of its principals (and, sometimes the fund itself) are reporting persons on these schedules.

A quarterly Form 13F filing with the SEC is generally required if in the prior year the assets (other than personal assets) managed at the end of any month by the manager were in excess of $100 million in equity securities (typically, publicly-traded long U.S. equities, options, warrants and certain convertible securities) over which there is investment discretion. The SEC provides a quarterly list of the securities disclosable on Form 13F.

A Form 3, 4 or 5 filing with the SEC, the issuer and the applicable exchange is generally required by a director, officer or a 10% or more beneficial owner of any class of a publicly-traded "equity" security or derivative security registered under the Exchange Act (looking at all accounts over which there is investment discretion). Under Section 16 of the Exchange Act, "short swing profits" may have to be disgorged to the issuer with respect to purchases and sales or sales and purchases made within six months of each other (which, for purposes hereof, may include routine transactions such as rebalancing trades and in-kind distributions). Generally, Form 3 filings are required within 10 days after the initial trigger is met, Form 4 filings are required within two business days after a transaction in the subject security to reflect certain changes in ownership status, and Form 5 filings are required annually to reflect certain other ownership changes. The manager and certain of its principals (and, sometimes the fund) are reporting persons on these forms.

Hart Scott Rodino Antitrust Improvements Act of 1976

A filing with both the Federal Trade Commission and the Department of Justice is usually required for each

fund prior to any acquisition that results in an aggregate position of $50 million or more in the assets and/or voting securities of an issuer being held (regardless of whether the voting securities are publicly-traded). A fee ranging from $45,000 for transactions below $100 million to $280,000 for transactions of $500 million or more must accompany the filing. However, if a private investment fund is able to satisfy either the passive investor exemption (i.e., the acquisition is solely for investment and the acquiring person would end up holding no more than 10% of the issuer's voting shares) or the institutional investor exemption (i.e., generally, banks, insurance companies, broker-dealers, registered investment companies and similar institutions), it will not have to make a filing.

Generally Accepted Accounting Principles ("U.S. GAAP")

Under Statements of Position 95-2 and 01-1, private investment funds whose audited financial statements are prepared in accordance with U.S. GAAP are required, in a condensed schedule of investments, to categorize their investments by security type, by country or region, and by industry. In addition, disclosure of investments constituting more than 5% of net assets must be made. While some private investment funds have previously provided financial statements that take an exception to U.S. GAAP and thus avoid having to make these disclosures, an April 2003 auditing interpretation will no longer permit such an exception and will generally require such information to be provided.

CUSTOMER/CLIENT INFORMATION REQUIREMENTS

Various rules have been passed by the SEC, FTC and CFTC requiring disclosure to certain U.S. clients of the firm's privacy procedures, whenever a new client relationship is established and on an annual basis thereafter. A paragraph outlining such procedures may be added to the fund's subscription agreement and such policy must also be given out on an annual basis. The privacy rules are applicable to registered and unregistered investment advisers, as well as commodity pool operators.

The FTC has also adopted a related rule requiring all financial institutions, including private investment funds, to adopt a written program which contains administrative, technical and physical safeguards appropriate to their situation to protect the security, confidentiality and integrity of customer information from unauthorized disclosure, misuse, alteration or destruction. The program should, among other things, designate a coordinating employee and identify foreseeable internal and external risks. Moreover, service providers dealing with such information (e.g., administrators) will have to contractually agree to comply with the rule.

ANTI-MONEY LAUNDERING REQUIREMENTS

Since the passage of the USA PATRIOT Act in late 2001, there have been various regulatory proposals relating to anti-money laundering made by the U.S. Treasury Department ("Treasury"). On September 18, 2002, the Treasury issued a proposed rule governing all Section 3(c)(1) and 3(c)(7) private investment funds that: (i) have $1 million or more in assets, (ii) are organized under the laws of the U.S. or any state therein, organized, operated or sponsored by a U.S. person, or sell ownership interests to any U.S. person, and (iii) permit their owners to redeem interests within two years of their purchase. While most hedge funds would be covered by the rule, most private equity funds and venture capital funds would be exempt. The proposed rule requires that, within 90 days following the publication of a final rule, funds covered by the rule must implement a written AML program "reasonably designed to prevent the company from being used for money laundering or the financing of terrorist activities". Each institution will be expected to tailor its program to fit its particular business, taking into consideration its size, activities, location, risks and vulnerabilities. The four required elements of an AML program would include the: (i) development of internal policies, procedures and controls, (ii) provision for independent testing, (iii) designation of a compliance officer, and (iv) establishment of an ongoing employee training program. Moreover, the proposed rule also contains a requirement that a fund file a notice with the Treasury no later than 90 days after it first becomes subject to the rule. The notice must include certain information about the fund, the fund's manager, sponsor and compliance officer, total assets under management, and the number of investors in the fund.

On December 31, 2002, the Treasury, the U.S. Federal Reserve and the SEC issued a joint report to the U.S. Congress pursuant to the USA PATRIOT Act with respect to private investment funds that recommends: (i)

adoption of the above rule and (ii) requiring all covered funds to establish customer identification and verification programs.

While final action is still pending as of the writing of this chapter, many private investment funds have already begun to adopt anti-money laundering programs in anticipation of final rules, and in response to similar rules affecting their funds passed in other jurisdictions and/or rules that may be imposed on their fund by fund service providers who are themselves subject to their own anti-money laundering requirements.

U.S. TAX CONSIDERATIONS

Depending on the fund's jurisdiction, the location of its manager, the location and tax status of its investors, as well as the securities and other instruments that the fund is trading, there may be pertinent U.S. tax issues that will need to be dealt with, including, without limitation, structuring the management companies and the funds, making "check-the-box" elections, providing tax and other information to certain investors, determining trader/investor status, establishing fee deferral arrangements for the manager, dealing with applicable tax shelter regulations, and many other items.

STATE AND LOCAL ISSUES

Blue Sky Filings

Private investment funds making offers and sales to U.S. investors will need to comply with applicable state "blue sky" laws. Generally, a state blue sky filing will need to be made within 15 days after the first sale of a fund interest in each state (other than New York, which requires a filing before the first offer), and a one-time filing of a Form D will have to be made with the SEC after the first sale by the fund. Non-U.S. funds will also be required to make blue sky filings with regard to their U.S. investors. Amendments to such filings may be required if material changes occur or as otherwise may be required by the applicable state's law. A number of states (e.g., Florida, New Jersey, Colorado, Illinois) have de minimis, institutional investor or other exemptions; however, before relying on any such exemptions, counsel should be consulted.

Investment Adviser Registration

There are also state-specific rules that may require state investment adviser registration, even if the manager is exempt from SEC registration, especially where the manager's principal office is located in such state. While many states have de minimis or institutional investor exemptions, in a number of states (e.g., Texas), registration will virtually always be required.

Taxation

A manager needs to also be aware of the tax issues in the state in which it and/or the fund is located, both at the state and local levels. An analysis of such issues may result in a different structure for the fund and/or its management vehicles.

CONCLUSION

The U.S. regulation of private investment funds continues to evolve. As the SEC, the U.S. Senate, the U.S. House of Representatives, the Treasury and other regulators conduct their own investigations of the industry, possible results may include: (i) requiring managers to register as investment advisers with the SEC (either by eliminating the fewer than 15 clients exception or requiring managers having a certain level of assets under management to register), (ii) requiring increased publicly available information regarding investments, and (iii) changing the investor criteria necessary to invest in private investment funds. ■