

Private Equity and Hedge Funds: Regulatory Analysis and Structural Overview

At Fox Rothschild LLP, we have a wealth of experience in creating and forming private equity and hedge funds. Over the years, our strategy has been to work with our clients to develop these entities while also assisting them in their ongoing business operations. As a result of the breadth of our experience, we have produced this handbook as a reference guide for all those who are interested in this exciting field, from potential entrants to those who may be more established and need a quick reference guide.

Anticipating your interest in these fund offerings, the following is meant to provide a summary of the most common compliance-related issues that private equity and/or hedge funds face. Of course, every issue that you may encounter in raising capital is not covered. Therefore, if an issue should arise, we suggest that you contact us with any questions or concerns. Please keep in mind that any deviation from the current statutory and regulatory structure (primarily based in exemptions and exceptions to provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940 and the Investment Company Act of 1940) for your private equity or hedge fund could subject you and your associates to significant liability.

This handbook has been prepared in three parts. The first part provides a summary of regulatory issues affecting hedge fund formation and operation. The second part contains a generic “Summary of Terms,” like what would be incorporated within a typical private placement memorandum. In the “Summary of Terms,” we have tried to identify the types of issues that would be relevant for you as a start-up fund and as a baseline for discussion and modification. Finally,

the third part is a questionnaire that may be used to focus thoughts on the creation of a fund.*

Section 1: Regulatory Analysis

Private Equity and Hedge Funds: Definitions

Within the private equity fund arena, there are various well-recognized categories of private equity funds. Those funds include, among others: venture capital funds; leveraged buyout or merchant banking funds; hedge funds; funds of funds; and real estate funds. Although we will primarily focus on hedge fund formation, many of the issues discussed below relate to the other categories of private equity funds as well.

The terms “private equity fund” “venture capital fund” or “hedge fund” are not defined or used in any federal securities law. In fact, the very creation and existence of these funds are primarily designed to operate outside the regulatory requirements that usually govern investment companies. Thus, these terms are more amorphous, used to describe: a privately organized, pooled investment vehicle managed by a professional investment manager that often engages in active trading in either a group of securities or commodities, including equities, government securities, municipal securities, futures, options, and foreign currencies. These funds usually employ sophisticated investment techniques, including arbitrage, leveraging, and hedging. Hedge funds are generally neither registered under the Securities Act of 1933 as amended (Securities Act), nor the Investment Company Act of 1940 as amended (Company Act).

A private-equity fund (including a venture capital fund) is a collective investment scheme used for making investments in various equity (and to a

** This handbook has been prepared for internal use only as a generic summary guideline of the regulatory issues affecting private equity and hedge fund formation and operation. It has not been customized for the use of the recipient or to address any specific issues that may be particular to the recipient. This material, absent separate written confirmation by a Fox Rothschild attorney, is not to be relied upon as legal advice, an opinion of Fox Rothschild or as a current statement of the law. Further, this handbook remains the property of Fox Rothschild and is not to be reproduced or provided to any third party.*

lesser extent debt) securities according to one of the investment strategies associated with private equity. Private equity funds are typically limited partnerships with a fixed term of 1 to 10 years (often with annual extensions). At inception, institutional investors make an unfunded commitment to the limited partnership, which is then drawn over the term of the fund. From the investors' point of view, funds can be traditional (where all the investors invest with equal terms) or asymmetric (where different investors have different terms). A private-equity fund is raised and managed by investment professionals of a specific private-equity firm (the general partner and investment advisor). Typically, a single private-equity firm will manage a series of distinct private-equity funds and will attempt to raise a new fund every 3 to 5 years as the previous fund is fully invested.

A venture capital fund is a type of private equity fund, although venture capital funds are typically thought of as being distinct from private equity. A traditional private equity fund will invest in operating, cash flow positive companies and will often leverage the equity investment with debt. Venture capital funds typically invest in early state, pre-cash flow positive companies and often make multiple rounds of investments in a single company.

As indicated above, the term "hedge fund" is not defined or used in any federal securities law. In fact, the very creation and existence of hedge funds are primarily designed to operate outside the regulatory requirements that usually govern investment companies. Thus, the term hedge fund is more amorphous, used to describe: a privately organized, pooled investment vehicle managed by a professional investment manager that often engages in active trading in either a group of securities or commodities, including equities, government securities, municipal securities, futures, options, and foreign currencies. Hedge funds usually employ sophisticated investment techniques, including arbitrage, leveraging, and hedging. Hedge funds are

generally neither registered under the Securities Act, nor the Company Act.

However, anyone in this field must remember that the very creation and existence of private equity and hedge funds are primarily designed to operate outside the regulatory requirements that usually govern investment companies.

One item before we leave our definitions is the concept of a REIT, a "Real Estate Investment Trust." A REIT is traditionally organized as a partnership, corporation, trust, or association that invests directly in real estate through the purchase of properties or by buying up mortgages. REITs issue shares that trade on a stock exchange and are bought and sold like ordinary stocks. To be considered a REIT, the company must invest at least 75% of its assets in real estate and derive at least 75% of its revenues from real estate-related activities. A REIT is not a private equity or hedge fund, but private equity and hedge funds are used to invest in real estate, mortgages, or other investments related to real property.

Organization

These funds are typically organized as private limited partnerships or limited liability companies with a general partner or managing member. In rare circumstances, certain of these funds are occasionally registered with the United States Securities and Exchange Commission (SEC).

Investors in these funds purchase a share of the fund in return for a fixed percentage of the funds' profits, minus fees. These funds ordinarily require significant investments, restrict transferability of the fund interest, and limit the times when an investor may redeem its fund interest.

Unlike mutual funds, which are subject to mandated liquidity provisions, private equity and hedge funds are free to develop their own redemption rules. Typically, these take the form of "lock-up" provisions that restrict the redemption or sale of shares for an enumerated period. Private equity/venture capital funds typically provide for liquidity only upon a monetization of an investment.

Investment Manager and Compensation

This person manages the fund and either makes investment decisions or selects the person who will make the investment decisions.

The fund manager customarily earns compensation that is tied to the performance of the fund. This compensation is referred to as a “performance fee.” Performance fees can range from 10 percent to 20 percent and are earned when the hedge fund experiences a positive return. The fund manager also earns from 1 percent to 2 percent of all assets as an annual fee.

Performance fee calculations usually also incorporate a high watermark concept requiring the hedge fund manager to make up any prior un-recouped losses before earning a performance fee from current profits. Some funds also incorporate a “hurdle rate,” requiring the fund to exceed a certain minimal rate of return before the performance fee is assessed.

There are variances; several funds charge significantly greater fees, assess a fixed asset-based fee, and/or pass through certain expenses to the investor. Fees can be apportioned directly to the withdrawals from the fund, rather than based on a period of at least 12 months, as is the case with mutual funds.

Investors

Most funds market fund interests solely to institutional investors or wealthy, sophisticated individuals. There are two types of investors: accredited investors and qualified purchasers.

Accredited investors are defined to include, among other things, any bank; broker or dealer; limited liability company with assets in excess of \$5 million; any natural person with an individual or joint net worth with that person’s spouse at the time of purchase exceeding \$1 million (excluding the value of the person’s primary residence and certain associated debt); and any natural person whose individual income is in excess of \$200,000 (or joint with a spouse in excess of \$300,000)

for the two most recent years. See 17 C.F.R. § 230.501 and 15 U.S.C. §80b-1. Interests in the fund must be offered exclusively to accredited investors, as that term is defined in SEC Securities Act Rule 501 of Regulation D. Be advised that in addition to the foregoing, there are other categories of investors that are also considered accredited. Please refer to SEC Securities Act Rule 501 for a complete list of categories or call us for more information.

The SEC’s Advisory Committee on Small and Emerging Companies has led discussions about amending the definition of an “accredited investor.” The SEC – which must review the definition every four years per the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) – issued a report in December 2015 seeking comments.

In 2020, the SEC amended the definition of an “accredited investor.” Generally, the amendments did not change the income limits, but the SEC expanded the definition of accredited investors to include individuals more knowledgeable about investing, such as those who have passed certain examinations and private equity and hedge fund traders, among others.

The other form of investor is a qualified purchaser, defined to include, inter alia: any natural person who owns at least \$5 million in investments; a family owned company that has more than \$5 million in assets; and any other person who, in the aggregate, either owns or invests at least \$25 million for its own account or the accounts of other qualified purchasers. See Company Act §2(a)(51)(A).

Regardless of the type of investor, investors are also relevant in determining whether a fund can qualify for an exemption from registration under the Investment Company Act. This is desirable to avoid the host of regulations that flow from registration. To qualify for an exemption, a fund may not: (1) be beneficially owned by more than 100 people (if sold to accredited investors); and

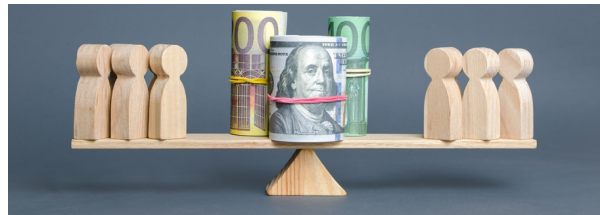
(2) may not make or presently propose to make a public offering of its securities. See Company Act § 3(c)(1). Alternatively, there is no limit to the number of investors a fund may have (and still qualify for an exemption) if: (1) all investors are qualified purchasers; and (2) the fund does not make or presently propose to make a public offering of its securities. See Company Act §3(c)(7). However, while there is no explicit investor limitation found in Company Act Section 3(c)(7), such as the 100 beneficial owner limitation found in Company Act Section 3(c)(1), for a Company Act Section 3(c)(7) fund to avoid being considered a “reporting company” pursuant to the Securities Exchange Act of 1934 (Exchange Act), it may not have more than (i) 2,000 investors, or (ii) 500 non-accredited investors. “Knowledgeable employees” are senior executives and upper management, and do not need to be qualified purchasers to invest in a Company Act Section 3(c)(7) fund. It follows that those interested in a fund must be ever vigilant before undertaking business ventures with a fund to ensure that it is not subsumed in some inappropriate venture disguised as a private equity or hedge fund. Nonetheless, if a fund wishes to pay incentive compensation (e.g., carried interest) and it is relying on the Company Act Section 3(c)(1) exemption from registration under the Company Act, the fund must comply with the Advisers Act’s “qualified client” rules. Pursuant to the Investment Advisers Act of 1940 (Advisers Act), a fund may charge incentive compensation only to investors who meet the qualified client rules (discussed below), or who are qualified purchasers.

The Fund Business Is Not ‘Regulation-Less’

Although, at first blush, these funds provide an appearance that the industry is some by-product of the “wild west,” there are, in fact, significant hurdles to overcome before entering this world. There are numerous regulatory considerations when organizing and operating a domestic fund as well as when engaging in business with a private equity or hedge fund. Many of these

considerations arise from the interpretation, application, and interplay of various statutes, including the Securities Act, the Exchange Act, the Advisers Act, and the Company Act, as well as state blue sky laws, the Commodity Exchange Act (Commodity Act) and applicable tax laws and regulations.

Offering Funds to the Public and the Securities Act



To qualify for exemption from the registration requirement, the Securities Act requires private equity and hedge funds offered in the United States to structure their offers and sales of interests as private placements. Consequently, the vast majority of these funds are offered as private placements, pursuant to a Securities Act Section 4(2) offering exemption. The SEC and courts review several factors to determine if an offering is public or private, including the number of offerees, the sophistication of the offerees, the nature of the information disseminated and the manner of the solicitation.

Private placements are generally made in accordance with Securities Act Rule 506 of Regulation D, a nonexclusive safe harbor for issuers relying on Securities Act Section 4(2). Securities Act Rule 506 of Regulation D permits sales of fund interests to an unlimited number of “accredited investors.” A fund may sell to a maximum of 35 non-accredited investors as well. Securities Act Rule 506 does not limit the dollar amount of securities that can be offered.

Until recently, Securities Act Rule 502(c) of Regulation D prohibited offers or sales through general solicitations or general advertising. Under this rule, you were not able to use cold calling,

advertising, mass emails or spam, websites, or other similar forms of promotion to solicit investors or promote or solicit investment in your hedge fund. However, on April 5, 2012, the Jumpstart Our Business Startups Act of 2012 (JOBS Act) was signed into law by President Obama. The JOBS Act directed the SEC to revise Regulation D within 90 days of its enactment to remove the prohibition on general solicitations and general advertising in offerings and sales made under Rule 506, provided that all actual buyers are accredited investors. To comply with the JOBS Act, the SEC now permits funds to broadly solicit and generally advertise an offering provided that all the investors in the offering are accredited investors. It follows, then, that a fund may not sell to 35 “non-accredited” investors while also performing general advertising.

In evaluating if a fund has complied with the requirements for Regulation D private offerings, the SEC looks at the relationship between the issuer and offeree and the method of solicitation to evaluate compliance with these requirements. To help establish that you have complied with the requirements of SEC Regulation D, we generally recommend that you maintain a log sheet to track each set of offering documents that are provided to a potential investor. Each private placement memorandum (PPM) sent to an investor should be consecutively numbered, and a record should be made of the person’s name and

address. If the person decides not to invest, every effort should be made to have that person return the PPM and related documents within a reasonable time.

Finally, a notice of sale on a Securities Act Form D must be filed within 15 days of the first sale under Securities Act Regulation D with the SEC and various states. Failure to file will usually – absent other circumstances--not adversely affect the availability of the exemption but may serve as a basis for the SEC to deny the issuer future reliance on Securities Act Regulation D. Further, it is

imperative to update counsel as to when the first investment is received so that counsel may file the Securities Act Form D on behalf of the private equity and hedge fund.

The Company Act and the Fund as a Private Pool of Capital

Funds are typically organized to avoid the compliance requirements of the Company Act by restricting the fund to less than 100 private investors, or to only “qualified purchasers.”

A domestic fund investing in securities is required to register as an investment company under the Company Act, absent an exemption from the definition of the term “investment company.” Section 3(c)(1) of the Company Act provides the applicable exemptions for an investment vehicle that meets two tests: (1) it must have no more than 100 beneficial owners; and (2) it must not make or propose to make any public offering of its securities.

The SEC has taken the position that the requirements under Company Act Section 3(c)(1) are met if the offering of securities meets the criteria of Section 4(2) of the Securities Act, or of Rule 506 of Regulation D.

To determine the number of beneficial owners of a fund, each individual investor is counted separately. However, a fund jointly owned by both spouses is considered owned by one beneficial owner. An investing entity that owns less than 10 percent of the outstanding voting securities of a fund will be considered one person. Prior to the enactment of the National Securities Markets Improvement Act of 1996 (NSMIA), an entity that owned 10 percent or more of the outstanding voting securities of a fund was considered one person for purposes of the 100 beneficial owner test only if the value of all of its holdings of Company Act Section 3(c)(1) excluded investment companies did not exceed 10 percent of the investing entity’s assets (Second 10 Percent Test). If the investing entity failed this Second

10 Percent Test, one was required to “look through” the entity to its beneficial owners, each of whom would then be considered a beneficial owner of the hedge fund. NSMIA eliminated the Second 10 Percent Test and counts an owner of any percentage of the hedge fund as one person for purposes of the 100 beneficial owner test, except where the 10 percent or more owner is an investment company, including those companies exempted under Company Act Sections 3(c)(1) and 3(c)(7).

An entity that is not a public or private investment company will be able to own more than 10 percent of a Company Act Section 3(c)(1) fund and count as one beneficial owner for purposes of the 100-person beneficial owner limit. Company Act Section 3(c)(1) funds will, however, always be required to “look through” with respect to public or private investment companies that own over 10 percent of their voting securities. Since the amendments to Company Act Section 3(c)(1) were intended to simplify application of the statute and not disrupt existing investment relationships, Company Act Rule 3c-1 was adopted and provides that the amended look-through provision will not apply in the case of an investor that held more than 10 percent of the outstanding voting securities of a Company Act Section 3(c)(1) fund on or before April 1, 1997, provided that the investor continues to satisfy the Second 10 Percent Test.

The SEC has stated that, as a general matter, the determination if an investor is subject to the amended look through provision must be made each time the investor acquires a voting security of a Company Act Section 3(c)(1) fund. In other words, the inquiry is made at the time of investment.

As a result, the look through provision will not be applied if the investor’s proportionate share of the fund’s voting securities increased because of another investor’s withdrawal, unless the withdrawal was part of a series of transactions designed to circumvent the look-through provision.

NSMIA also added a new exception from the definition of investment company under Company Act Section 3(c)(7), covering an investment pool that does not make or propose to make a public offering of its securities and whose securities are held exclusively by “Qualified Purchasers.” Absent the considerations previously discussed, a Company Act Section 3(c)(7) fund could in theory have an unlimited number of Qualified Purchaser investors. Qualified Purchasers are defined in Section 2(a)(51)(A) of the Company Act as: any natural person (including any person who holds a joint, community property or other similar shared ownership interest in an issuer that is excepted under Company Act Section 3(c)(7) with that person’s qualified purchaser spouse) who owns not less than \$5 million of investments, as defined by the SEC; any company (Family Company) that owns not less than \$5 million in investments and that is owned, directly or indirectly, by or for two or more natural persons who are related or by such persons’ estates, foundations, charitable organizations or trusts; any trust that is not covered by clause (b) and that was not formed for the specific purpose of acquiring the securities offered, as to where the trustee or other person authorized to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a person described in clauses (a), (b) or (d); and any person (e.g., an institutional investor), acting for its own account or the accounts of other Qualified Purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25 million in investments.

Additionally, Company Act Rule 2a51-1 provides that, with two exceptions, a Qualified Institutional Buyer (QIB), as defined by Rule 144A(a) under the Securities Act, is deemed to be a Qualified Purchaser. Securities Act Rule 144A generally defines QIBs as: certain institutions that own and invest on a discretionary basis \$100 million of securities of issuers that are not affiliated with the institution (QIB Securities); banks that own and invest on a discretionary basis \$100 million

of QIB Securities and that have an audited net worth of at least \$25 million and certain registered dealers that own and invest on a discretionary basis \$10 million of QIB Securities. The first exception pertains to dealers and coordinates the definition of QIB with that of Qualified Purchaser by requiring the dealer to own and invest on a discretionary basis \$25 million of QIB Securities. A dealer may meet the Qualified Purchaser test by owning and investing on a discretionary basis \$25 million of investments in accordance with Company Act Rule 2a51-1.

The second exception pertains to self-directed employee benefit plans such as 401(k) plans. These plans will not be considered to be Qualified Purchasers unless each of the participants in these plans are themselves Qualified Purchasers. Company Act Rule 2a51-1 defines “investments” broadly for purposes of determining whether the \$5 million and \$25 million Qualified Purchaser thresholds have been met. Investments include the following: securities, except for securities that constitute a “control interest” in issuers other than (i) investment vehicles excluded or exempted from the definition of investment company by Company Act Sections 3(c)(1) through 3(c)(9) or Rules 3a-6 or 3a-7 under the Company Act, (ii) public companies or (iii) large private companies having shareholders’ equity of \$50 million or more; real estate held for investment purposes (this will exclude the personal residence of and property used as a place of business by the prospective Qualified Purchaser); commodity interests, physical commodities and financial contracts that are held or entered into for investment purposes; and cash and cash equivalents held for investment purposes including bank deposits, certificates of deposit, bankers acceptances and similar bank instruments as well as the net cash surrender value of insurance policies.

Investments may be valued based either on their fair market value or cost and must take into account indebtedness incurred to acquire an investment. A Company Act Section 3(c)(7) fund need only have a reasonable belief that

the investor is a Qualified Purchaser based upon the investor’s representations, but the investor’s status must be assessed each time the investor acquires securities of the fund unless subsequent acquisitions are pursuant to a binding agreement requiring installments or periodic capital calls. Company Act Rule 3c-5 permits “knowledgeable employees” of a fund and certain of its affiliates to acquire securities issued by the fund without being counted for purposes of Company Act Section 3(c)(1)’s 100 investor limit and permits such employees to invest in a Company Act Section 3(c)(7) fund without meeting the Qualified Purchaser test. It defines a “knowledgeable employee” to include executive officers, directors, trustees, general partners and advisory board members of the fund or its manager as well as other experienced employees who participate in the fund’s investment activities.

To preclude circumvention of the requirements of Company Act Section 3(c)(1), the SEC has required distinct Company Act Section 3(c)(1) funds to be “integrated” for purposes of determining whether they have exceeded the 100 investor limitation if a reasonable investor would view the two funds as being essentially the same based on such factors as the strategies being pursued, the composition of their portfolios and their risk/return characteristics. NSMIA provides, in Company Act Section 3(c)(7)(E), that a Company Act Section 3(c)(1) fund and a Company Act Section 3(c)(7) fund will not be treated as a single issuer by the SEC. Thus, even if the two funds are managed in a similar fashion, the investors in a Company Act Section 3(c)(7) fund will not be included in determining the Company Act Section 3(c)(1) fund’s compliance with the 100 investor limitation. Conversely, nonqualified purchaser investors in the Company Act Section 3(c)(1) fund will not impair the status of the Company Act Section 3(c)(7) fund.

We do note that, in 2020, the SEC somewhat relaxed the integration test, but the essential regulatory structure remains in place.

Securities Act Rule 152: General Principle of Integration and Non-Exclusive Integration Safe Harbors

The approach to integration changed dramatically with Securities Act Release No. 33-10884 (Nov. 2, 2020). The SEC disavowed the multifactor test and removed from the offering safe harbors their individualized treatments of integration. In their place, the SEC adopted Securities Act Rule 152. Securities Act Rule 152(a) provides a general framework for considering integration, and Rule 152(b) provides four broad integration safe harbors.

The pivotal consideration in Securities Act Rule 152 is if the exemption for the offering permits general solicitation. This focus is based on the belief that if each offering exemption permits general solicitation (and thereby recognizing that among those solicited there will be some or many who do not meet the exemptions criteria) the policy of each exemption is not violated if simultaneously sales are made to other investors who meet the criteria of another exemption that also permits general solicitation.

The SEC has identified the following exemptions as those permitting general solicitation: Regulation A, Regulation Crowdfunding, Rule 147 or 147A, Rules 504(b)(1)(i), (ii) or (iii) Rule 506(c). The following exempt offerings do not permit general solicitations: Rule 504(b), Rule 506(b), Securities Act Section 4(a)(2). See Securities Act Release No. 33-10884, Tbl. 3 (Nov. 2, 2020).

Sweeping protection from integration is set forth in Securities Act Rule 152(b)(1) for offers that are separated by more than 30 calendar days between the termination of the earlier offer and the commencement of the later offer. Securities Act Rule 152(c) & (d) sets forth in some detail what constitutes the commencement and termination of an offering. However, where an exempt offering that does not permit a general solicitation follows an offering that allows general solicitation, this integration safe harbor requires that the issuer (or anyone acting on its behalf) in connection

with the later offering either: Did not solicit the purchaser through the use of general solicitation, or establishes a substantive relationship with the purchaser prior to the commencement of the later offering. A less qualified safe harbor is Securities Act Rule 152(b)(4). An offer carried out pursuant to an exemption that permits general solicitation is not integrated with any earlier offer. Hence, this safe harbor is met if either all offerings are carried out pursuant to an exemption that permits general solicitation or, for example, there are two offerings where the earlier offering bars general solicitations, but the later offering permits general solicitation. Unlike the safe harbor in Securities Act Rule 152(b)(1), there is no 30-calendar day separation period. Securities Act Rule 152(b)(3) provides a safe harbor from integration for an offering if a registration statement is filed following: a terminated or completed exempt offering for which general solicitation is not permitted; a terminated or completed exempt offering for which general solicitation is permitted made only to qualified institutional buyers and institutional investors; or an exempt offering for which general solicitation is permitted that terminated or completed more than 30 days prior to the commencement of the registered offering. Securities Act Rule 152(b)(2) provides a safe harbor for all offers and sales pursuant to an employee benefit plan complying with Rule 701 or that complies with Regulation S.

If none of the preceding four safe harbors apply, Securities Act Rule 152(a) provides that offers will not be integrated provided “the issuer can establish that each offering either complies with the registration requirements of the act, or that an exemption from registration is available for the particular offering.” This language would seem to invite consideration of the factors of integration. However, the adopting release suggests otherwise, stating “[t]he final rules replaces the five-factor test with the Commission’s more recent approach to integration.” The approach being referred to was in some pre-2021 safe harbor provisions holding that an offer that complied with the requirements

of a particular exemption would not integrate with any earlier transactions and in some cases with even subsequently undertaken transactions. The release's blanket statement and broad approach in Securities Act Rule 152(a) is, however, tempered by the Rule 152's introductory paragraph admonishing that Rule 152 "will not have the effect of avoiding integration for any transaction or series of transactions that, although in technical compliance ... is part of a plan or scheme to evade the registration requirements of the Act."

The omnibus integration safe harbor provided by Securities Act Rule 152(a) is not without conditions, and those conditions suggest the type of circumvention that most concerns the Commission, namely, is the offering promoted through a general solicitation? Hence, as was seen with Securities Act Rule 152(b), there is a tight focus in paragraph (a) on if the relied upon exemption permits general solicitation. As seen above, Securities Act Rule 152(b)(4) does not integrate a subsequent offer with a prior offer if the subsequent offer is pursuant to an exemption that permits general solicitation, even though the prior offer bars general solicitations. Thus, if the subsequent offer is a Securities Act Rule 506(b), whether there should be integration would be resolved under paragraph (a) of Rule 152. Under Rule 152(a)(1) integration is avoided if the issuer or those acting for it must establish: they did not solicit any purchaser in the offering prohibiting general solicitation through the use of general solicitation; or they can establish there was a substantive relationship with such purchaser prior to the commencement of the exempt offering prohibiting general solicitation. The release defined "substantive relationship" meaning the issuer or its representative "has sufficient information to evaluate, and does, in fact, evaluate, an offeree's financial circumstances and sophistication, in determining his or her status as an accredited or investor."

If both offerings prohibit general solicitation, Securities Act Rule 152 (a) (1) governs this situation with reasoning that mirrors that above, the two offers fall within the Rule 152(a)(1) safe

harbor if each purchaser in was not solicited by a general solicitation or had the requisite preexisting relationship. When two or more concurrent offerings are conducted and each permits general solicitation, Rule 152(a)(2) provides for no integration if in addition to satisfying the requirements of each exemption relied upon, to avoid integration, the issuer should ensure that the materials used for the solicitation comply with the content and legend requirements of both types of offerings.

The Investment Manager and the Advisers Act

The Advisers Act regulates the activities of investment advisers. The manager of a fund generally will fall within the definition of an "investment adviser" under Section 202(a) (11) of the Advisers Act. Prior to the enactment of the Dodd-Frank Act, the fund manager was typically exempt from registering as an investment adviser under the "private adviser exemption" of the Advisers Act. Further, before the Dodd-Frank Act, a person was exempt from registration pursuant to the Advisers Act if the person did not have more than 15 clients. The Dodd-Frank Act amended the Advisers Act to eliminate the private investment adviser exemption, requiring advisers to private funds to register with the SEC unless the adviser could rely upon an alternative registration exemption.

Those Dodd-Frank Act new registration exemptions under the Advisers Act are as follows:

- Advisers to Venture Capital Funds – Investment advisers that act as advisers solely to one or more venture capital funds are exempted from the registration requirements under the Advisers Act.
- Advisers with Limited Assets Under Management – Investment advisers that act solely as advisers to private funds and have assets under management in the U.S. of less than \$150 million are exempted from the registration requirements under the Advisers Act.
- Advisers to Family Offices – Investment advisers that act as advisers to "family offices" are excluded from the definition of investment

adviser under the Advisers Act and are therefore exempt from the registration requirements under the Advisers Act.

- Foreign Private Advisers – Investment advisers that are foreign private advisers are exempted from the registration requirements under the Advisers Act. A “foreign private adviser” is defined under the Dodd-Frank Act as an investment adviser that:
 - o Has no place of business in the U.S.
 - o Has fewer than 15 U.S. clients and investors in the private funds it advises.
 - o Has less than \$25 million (or a higher amount as the SEC deems appropriate) aggregate assets under management attributable to U.S. clients and U.S. investors in private funds it advises.
 - o Does not hold itself out as an investment adviser in the U.S. or act as an investment adviser to any investment company registered under the Advisers Act.
- Advisers to Small Business Investment Companies (SBICs) – Investment advisers that act as advisers solely to a “Small Business Investment Company” under the Small Business Investment Act of 1958 are exempted from the registration requirements under the Advisers Act.
- Advisers to Mid-Sized Private Funds – The Dodd-Frank Act provides that, in issuing registration and other regulations relating to Title IV of the Act (i.e., the recordkeeping and reporting requirements of the Act) concerning investment advisers to “mid-sized private funds,” the SEC should take into account the size, governance and investment strategy of such funds to determine whether they pose systematic risk and will set regulations which reflect the level of systematic risk posed by such funds. The Dodd-Frank Act does not define mid-sized private funds. However, given the exemption from registration for private funds with assets under management in the U.S. of less than \$150 million, the SEC will likely define mid-

sized private funds as funds having assets under management in excess of this \$150 million threshold up to a certain aggregate assets under management.

Prior to the enactment of NSMIA, investment advisers in the United States were subject to regulation at both the federal and state levels. The Investment Adviser Supervision Coordination Act (Coordination Act), which was adopted as part of NSMIA, reallocates regulatory responsibility between the SEC and state regulators based primarily on the size and scope of the investment adviser’s business.

Under the Coordination Act, an investment adviser that is regulated or required to be regulated in the state in which it maintains its principal office and place of business can only be registered with the SEC if it has \$25 million of assets under management or advises a registered investment company. Notably, state regulators are pre-empted from regulating advisers registered with the SEC. However, state regulators retain authority over SEC registered advisers under state investment adviser statutes to investigate and bring enforcement actions related to fraud or deceit. Additionally, state regulators have authority to require, for notice purposes, filings of documents filed with the SEC and payment of state filing, registration, and licensing fees.

Under the prior Advisers Act rules, a fund manager that qualified for the exemption from federal registration and that was managing less than \$25 million (and not advising a registered investment company) would be subject to state registration absent an exemption under state law. The Dodd-Frank Act amends the Advisers Act to add an additional federal registration exemption for mid-sized advisers, which are investment advisers with assets under management between \$25 million and \$100 million (or a higher amount to be determined by the SEC), if the adviser is subject to registration and examination as an investment adviser in the state of its principal office and place of business. However, if the adviser is subject

to registration with 15 or more states, then the adviser may register with the SEC. Generally, an adviser that qualifies for the “15 or more states” benchmark would register with the SEC to forego the costs of registering with so many different states.

The Dodd-Frank Act also modifies the existing intrastate adviser exemption under the Advisers Act (for advisers whose clients are all residents of the state where the adviser is principally located) by excluding investment advisers to private funds from this exemption. Thus, hedge funds, private equity funds and venture capital funds that only operate and advise in one state are now required to register with the SEC unless the advisers can rely on an alternative registration exemption.

Section 1-102(J) of the Pennsylvania Securities Act of 1972 exempts an investment adviser from state registration if the adviser has a place of business within the state and, during the preceding 12 month period, has not had more than five clients and does not hold himself out to the public as an adviser. Similar exemptions exist in other states.

Registration is of particular significance to funds because it imposes certain limitations on who can be charged performance-based compensation as well as requirements on how such compensation is calculated. Section 205(a) of the Advisers Act applies only to registered advisers, and, generally, prohibits performance based compensation. Advisers Act Rule 205-3 provides an exception to this general prohibition for performance-based fees charged to “Qualified Clients.”

Qualified Clients must: (i) have a net worth of at least \$2.1 million (excluding the value of the person’s primary residence and certain associated debt); (ii) have at least \$1 million under management by the adviser; (iii) be a “Qualified Purchaser” under Section 2(a)(51)(A) of the Company Act; or (iv) fall within certain categories of knowledgeable employees of the investment adviser. Note that the Dodd-Frank Act requires the SEC to analyze these thresholds every five years

to account for inflation. The most recent inflation-related adjustment occurred on June 14, 2016, when the SEC increased the “net worth” threshold from \$2 million to its current \$2.1 million. Due to the five year increments contemplated by the Dodd-Frank Act, the next inflation-related adjustment will not be required until 2021.

Generally, the individual investors in the fund, rather than the fund itself, are considered for purposes of this analysis and the conditions of Advisers Act Rule 205-3 must be applied separately to each investor. A Company Act Section 3(c)(1) fund will be deemed an eligible investor only if all its beneficial owners are eligible investors. However, a Company Act Section 3(c)(7) fund may enter a performance fee contract without requiring each investor to satisfy the eligibility criteria of Advisers Act Rule 205-3.

Exchange Act Requirements

The Exchange Act has several applications to the fund world, including broker-dealer registration to sell these interests, the size of the fund, disclosure of all material information, soft dollar arrangement prohibitions, ongoing disclosure obligations, adherence to stated investment policies and reporting requirements.

Generally, the Exchange Act requires broker-dealer registration to market and sell interests in private funds. However, broker registration of a fund or its manager generally will not be required because they are not “effecting transactions in securities for the account of others.” See Exchange Act § 3(a)(4). Similarly, dealer registration will not be required of the fund or its manager because the fund and its manager “buys or sells securities for such person’s own account, either individually or in a fiduciary capacity, but not as a part of a regular business.” See Exchange Act § 3(a)(5).

Most funds and their managers are not required to register because they are considered “traders” as opposed to brokers or dealers in that they do not possess the characteristics of a broker-dealer. In fact, funds and their managers are essentially

managing their own account on a continuous basis. Further, the fund and its manager do not possess other characteristics of a broker-dealer since they do not make a market in one or more securities or extend or arrange for the extension of credit in connection with securities activities.

However, problems can and do arise when third parties sell fund interests. Such arrangements require that the third parties register as a broker-dealer or be associated with a registered broker-dealer. Funds and their managers should be cautious when using the service of so-called “finders.” Finders are typically unregistered persons who seek to find investors for funds to earn a commission-type fee. The payment of success-based compensation to these individuals is unlawful. It is not uncommon for funds to seek advice as to whether they are permitted to pay “finder’s fees” to people who introduce investors to the fund. We recommend that funds only pay finder’s fees to entities that are registered as securities broker-dealers. The payment of finder’s fees to unregistered individuals or companies raises significant compliance concerns under federal and state securities laws.

Further, certain states prohibit such practices and provide investors with the opportunity to rescind their full investment if offers of securities are made in violation of the state’s securities laws. Interestingly, the need for finders may be obviated since the enactment of the JOBS Act permits general solicitations of the fund so long as the actual buyers are accredited investors.

Section 12(g) of the Exchange Act requires domestic issuers of securities with total assets exceeding \$10 million and a class of equity securities held by 2,000 or more persons to register that class of securities. As confirmed by the most recent amendments to the Exchange Act Rules, the asset and class size thresholds are evaluated on the last day of the most recent fiscal year. Employees who hold securities pursuant to an employee compensation plan do not count as record holders for the 2,000 person threshold,

and up to 500 of the 2,000 holders of record may be non-accredited investors. Until the passage of the JOBS Act, the record holder limit was 500. The administrative burdens of registration may effectively set the outer bounds of the number of investors in a domestic hedge fund at 1,999 (excluding employee-investors).

Additionally, the Exchange Act requires full disclosure of all material risks to potential investors. For example, when you discuss an investment opportunity with potential investors, it is important to balance the discussion and disclose all the material risks as well as the potential rewards of the investment. The securities laws require you to disclose all material information about the fund, the management team, the offering, and any other items to potential investors. Certain background information related to the fund’s managers such as criminal convictions, past SEC actions, bankruptcies and other items are considered material and need to be disclosed. All the information you provide to investors should be consistent with the information contained in the PPM and/or offering circular. If there have been material developments with respect to the fund or any of the management team, the PPM and/or offering circular will need to be updated. Under no circumstances should you make any guarantees that an investor will make a profit by investing in the fund.

The Exchange Act also prohibits soft dollar arrangements. Fund managers previously entered arrangements where a portion of the commissions generated in trading on behalf of the fund were used to purchase goods and services for the benefit of the fund manager. Such arrangements may raise questions of a conflict of interest when the fund manager effectively pays higher commissions for received goods and services that may not be fully beneficial to the fund on whose behalf the commissions were generated. The portion of commissions that exceeds the lowest available rate that is used to pay for such goods and services is referred to as “soft dollars.”

The Exchange Act also has several reporting requirements that may be applicable to private funds. These requirements are similar for other investors. For example, if the fund obtains a significant position in a company or the overall size of the fund's portfolio is substantial, reporting may be required.

Further, fund account statements must accurately represent fund performance. Regulators will pursue enforcement actions against managers personally for misrepresenting profits and losses and distributing false or misleading account statements. Similarly, funds must adhere to stated investment policies. Funds must pursue an investment strategy consistent with its representations to investors. Regulators will pursue enforcement actions against managers personally for losses incurred because of an undisclosed change in investment strategy.

The Exchange Act also imposes certain reporting on regulators. Initially, Exchange Act Sections 13(d) and 13(g) require disclosure. Once a person or group of persons have acquired direct or indirect beneficial ownership of more than 5 percent of a class of voting equity securities registered under the Exchange Act, a statement disclosing such ownership must be filed with the SEC with a copy sent to the issuer and, in the case of a filing under Exchange Act Section 13(d), every exchange on which the security is traded. The statement must be filed on Exchange Act Schedule 13D – also known as a “beneficial ownership report” – unless the filer can qualify to use Exchange Act Schedule 13G. Such Schedules are filed electronically via the SEC's EDGAR system.

A 13D beneficial ownership report must be filed within 10 days after the 5 percent threshold is breached, with the salient day being the trade date as opposed to the settlement date. Thereafter, amendments must be filed if there is a material change in the information previously disclosed, including a change of ownership of 1 percent or more of the outstanding class of securities. Information disclosed in the Exchange

Act Schedule 13D includes the identity of the purchaser, the purpose of the acquisition, the source of funds used to purchase the securities, voting power with respect to the securities owned and material contracts and arrangements with respect to the securities.

Exchange Act Schedule 13G is a short form available to three classes of investors provided that they have acquired the securities in the ordinary course of their business and not with the objective of changing or influencing control of the issuer. The three investor classes eligible to use Schedule 13G are: “qualified institutional investors” (including registered broker-dealers, most banks, insurance companies, registered investment companies and registered investment advisers); “exempt investors” (referring to persons holding more than 5 percent of a class of subject securities at the end of a calendar year, but who have not made the acquisition subject to Exchange Act Section 13(d)); and “passive investors” (investors (i) not seeking to acquire or influence “control” of an issuer and (ii) owning less than 20 percent of the outstanding shares of any class of securities of such issuer).

Qualified institutional investors and exempt investors must file their Exchange Act Schedule 13Gs and send copies within 45 days of the end of the calendar year in which the 5 percent threshold was breached

and within 10 days after the end of the first month in which beneficial ownership exceeds 10 percent and within 10 days of the end of any month thereafter in which such beneficial ownership increases or decreases by more than 5 percent as of the last day of such month. Annual filings are also required within 45 days of year end.

Passive investors choosing to report on Exchange Act Schedule 13G are required to file an Exchange Act Schedule 13G within 10 calendar days after acquiring beneficial ownership of more than 5 percent of a class of securities. An investor is not eligible, however, to file on Exchange Act Schedule 13G and must file an Exchange Act Schedule 13D if it has acquired beneficial ownership of

more than 5 percent of a class of voting securities and is unable or unwilling to certify that it is not seeking to acquire or influence “control” of the issuer. Passive investors using Exchange Act Schedule 13G are required to amend their filing within 45 days after the end of the calendar year to report any changes in the information previously filed.

Additionally, the amendments impose several safeguards against abuse of the less intensive reporting obligations of Exchange Act Section 13(g). Passive investors must promptly file an amendment to their Exchange Act Schedule 13G during the year after acquiring beneficial ownership exceeding 10 percent of the class of subject securities and, thereafter, upon any increase or decrease in beneficial ownership by more than 5 percent. When a qualified institutional investor or a passive investor no longer holds securities for passive purposes and when the passive investor’s holdings reach 20 percent or more, such investors will lose Exchange Act Schedule 13G eligibility and are required to file an Exchange Act Schedule 13D within 10 calendar days of that event and will become subject to a “cooling off” period that begins with the date of the triggering event and continues until 10 calendar days after the filing of the Exchange Act Schedule 13D. During this cooling-off period, the reporting person is prohibited from voting or directing the voting of the subject securities or acquiring additional equity securities of the issuer or any person controlling the issuer.

Exchange Act Section 13(f) also requires institutional investment managers with investment discretion over accounts holding Exchange Act Section 13(f) securities (voting securities traded on a national securities exchange or quoted on NASDAQ) with a fair market value of at least \$100 million to file a quarterly report on Exchange Act Form 13F with the SEC. Reports are to be filed within 45 days of the end of the first calendar year in which the \$100 million threshold is breached and within 45 days after each succeeding quarter of the subsequent year. The Form 13F

discloses all holdings of Exchange Act Section 13(f) securities in excess of 10,000 shares and \$200,000 in aggregate fair market value or principal amount in the case of convertible debt. Institutional investment managers who exercise investment discretion over \$100 million or more in Section 13(f) securities must report their holdings on Exchange Act Form 13F with the SEC. When a fund reaches \$100 million under management, there may be a requirement to file an Exchange Act Form 13F with the SEC.

Further, Exchange Act Section 16 requires “insider” filings. An “insider” under this section is a fund that acquires in excess of 10 percent of a class of voting equity securities registered under the Exchange Act. When a fund becomes an insider, it must make an initial filing with the SEC on Form 3, disclosing that its ownership position exceeds 10 percent. The insider must also file updates on Exchange Act Form 4 before the end of the second business day following the day on which a change in beneficial ownership occurs. Finally, the fund may have to make annual filings on Form 5 to report transactions in the security not otherwise reported. Section 16(b) also subjects the fund to an obligation to disgorge to the issuer any “short-swing” profits generated from the purchase and sale of the issuer’s securities within a six-month period. During the time a fund is an insider, Section 16(c) generally restricts short sales by prohibiting short sales unless the insider owns an amount of securities at least equal to the amount being sold short [a short against the box] and delivers the securities within 20 days of the sale or places them in the mail within five days of the sale.

The Dodd-Frank Act also amended the Advisers Act to require additional recordkeeping and reporting requirements for registered investment advisers to private funds in addition to mandating new examination and audit obligations for the SEC concerning these records and reports. The Dodd-Frank Act allows the SEC to require registered investment advisers to private funds to maintain these records for each private fund that they

advise and to file with the SEC any reports as the SEC deems “necessary and appropriate” in the public interest and for the protection of investors or for the assessment of systematic risk by the Financial Services Oversight Council (FSOC). Additionally, the Dodd-Frank Act mandates that the records and reports include a description of:

- The amount of assets under management and the usage of leverage, including off-balance sheet leverage.
- Counterparty credit risk exposure.
- Trading and investment positions.
- Valuation policies and practices of the fund.
- Types of assets held.
- Side arrangements or side letters that certain investors in a fund obtain more favorable rights or entitlements than other investors.
- Trading practices.
- Any other information the SEC, in consultation with the FSOC, may determine is necessary depending upon the type or size of private fund being advised.

The Dodd-Frank Act also requires the adviser to make all of these records and reports available to the SEC, and the SEC is allowed to share with the FSOC as necessary for it to assess systematic risk. The SEC must also schedule periodic examinations of all records maintained by registered investment advisers, and may conduct special examinations in its discretion when deemed necessary. All records and reports provided to the SEC must be kept confidential subject to certain customary exceptions.

On October 31, 2011, the SEC and the United States Commodities Futures Trading Commission (“CFTC”) released joint rules to implement certain additional reporting requirements of the Dodd-Frank Act. Under these rules, SEC-registered investment advisers with at least \$150 million in private funds under management must file a Form PF with the SEC. The Form PF will be used by the FSOC to monitor risk to the U.S. financial system.

Commodity Act

The Commodity Act also requires a fund to register as a commodity pool operator (CPO). For fund managers, they must register as a commodity trading adviser (CTA) if the fund trades on an organized futures exchange such as the Futures, Forex and Commodities. The Commodity Act also requires registration for a fund that trades futures contracts or commodity options or invests in another commodity pool. While there are some exceptions, fund managers should be aware that depending on the size, in terms of investors and net value, and the percentage of assets invested in commodities trading, a fund may have to register with the National Futures Association (NFA) and CFTC as a CPO.

Recently, the CFTC adopted a final rule that eliminated an exemption to registration that will significantly impact hedge funds and other private funds. Prior to the adoption of the rule, to qualify for the exemption, the interests in the pool must have been exempt from registration under the Securities Act and each participant must be a qualified eligible person or an accredited investor. Now that the exemption has been rescinded, any private fund operating under that exemption must register with the CFTC prior to December 31, 2012. However, funds may still qualify for other exemptions, such as the de minimis exception.

As a result, prudent planning is required before investing in any futures contracts or commodity options.

Anti-Fraud Provisions and Restrictions on Investment Types

Funds and their managers are subject to the anti-fraud provisions of the Securities, Exchange, Advisers, Company and Commodity Acts. Additionally, from time to time, regulations effectively ban certain trading strategies. For example, in 2008, the SEC adopted interim final temporary Rule 204T and Rule 10B-21, an anti-fraud provision designed to deter “naked” short selling. Oftentimes, these temporary regulations

are incorporated into final rules if their effects are deemed sufficiently beneficial. For example, after the adoption of temporary Rule 204T in 2008, the SEC adopted final Rule 204 in 2009, that was similar to Rule 204T with some modifications to address commentators' concerns. Additionally, the SEC is on a mission to rid the market of PIPE transactions. As such, the SEC is beginning to accuse hedge funds of acting as unregistered dealers to stop these transactions.

State Law Preemption

Funds and their managers are subject to the state securities laws in the states where they obtain investors, but there are also certain exemptions. It is critical to determine in advance the states where the fund will solicit investors to purchase interests in the fund. Each state has its own set of state securities laws known as blue sky laws, and compliance with these laws when raising money for the fund is imperative. Unless an exemption applies, the fund may have to file a notice with the states where investors reside. Some states may require notice filings and the payment of a fee before soliciting investors in the state, however, the largest, New York, recently adopted regulations that brought it into line with the majority of other states only requiring such notice filings and payment after the investments are made.

Additionally, prior to the passage of the NSMIA, private placements of funds were required to adhere to state statutes and regulations governing the offering of securities to state residents. Many of these states required filings to qualify the offering for exemption from registration. NSMIA amended Section 18 of the Securities Act to pre-empt state blue sky laws by prohibiting state governments from requiring registration or imposing merit regulation of offerings of "Covered Securities." Covered Securities include: sales to "qualified purchasers" (defined as accredited investors.); and sales in private transactions under rules or regulations issued under Section 4(2) of the Securities Act. This covers offerings made pursuant to Rule 506 of Regulation D. It does not

cover offerings exempt under Rules 504 or 505 of Regulation D or under Securities Act Rule 701 or Regulation A as these exemptions were adopted pursuant to Section 3(b) of the Securities Act.

As described above, states will not be prohibited from imposing notice filing requirements that are substantially like those required by rule or regulation under Section 4(2) of the Securities Act in effect as of September 1, 1996. Since Rule 503(a) of Regulation D requires the filing of a Securities Act Form D with the SEC not later than 15 days after the first sale of securities, the filing requirements of the states should now follow Securities Act Rule 503 in terms of the timing of the filing. Even if a state has not amended its securities law to require a notice filing pursuant to NSMIA, NSMIA, nonetheless, requires that issuers pay a filing fee to the state determined pursuant to state law as in effect on October 10, 1996.

States also regulate performance fees for fund managers. The fact that an adviser meets the safe harbor of Advisers Act Rule 205-3 does not prevent a state from further restricting performance fee arrangements if the adviser is subject to state regulation. Most states generally prohibit an investment adviser from charging performance fees, although a number of states, but not all states, provide an exception from such prohibition with respect to an investment adviser that follows Rule 205-3 under the Advisers Act or the version of that Rule that existed prior to its amendment on August 20, 1998.

Additionally, most states' definition of broker-dealer are a combination of the definitions of broker and dealer under the Exchange Act. Moreover, many states' securities laws contain provisions mandating such securities laws be interpreted to promote uniformity with other related and similar state statutes and federal regulation. Regarding the interpretation of state securities law definitions, state securities commissions and state courts, generally, follow with great deference, the SEC's interpretations of similar or identical terms under the federal securities laws. Accordingly, funds that are not

deemed to be brokers and/or dealers under the Exchange Act would usually not be deemed to be broker-dealers under state securities laws. However, a fund should carefully review the securities law of the state where it plans to conduct its business.

Finally, states also retained jurisdiction to investigate or bring enforcement actions with respect to fraud or deceit or unlawful conduct by a broker or dealer in connection with securities or securities transactions.

Tax and ERISA Considerations

Although mutual funds are subject to diversification requirements if they receive tax benefits (i.e., a certain percentage of the fund's assets are limited such that the fund may own no more than 10 percent of the outstanding securities of a portfolio company, and that the portfolio company stock may not constitute more than 5 percent of the value of the assets of the fund), funds are not subject to such diversification restrictions.

Section 7704 of the Internal Revenue Code of 1986, as amended (IRC) and related regulations provide that a partnership with more than 100 investors will be treated as a "publicly traded partnership" and taxed as a corporation if interests in the partnership are traded on an established securities market or a secondary market or the substantial equivalent of such a market. A partnership may be exempt from corporate tax status if it: (1) limits its income to "qualifying income;" (2) limits investor redemptions so as not to provide liquidity equivalent to a secondary market; or (3) limits the number of investors to 100.

Most funds also seek to avoid falling under the Plan Asset Regulations of the Employee Retirement Income Security Act of 1974 (ERISA) by ensuring that "benefit plan investors" hold, in the aggregate, less than 25 percent of the value of any class of equity interest in the fund. If this limit is exceeded, the fund will be considered to hold "plan assets" and could be subject to a

host of ERISA-related regulations. Congress has considered legislation that would make funds more accessible to benefit plan investors, such as limiting the definition of "benefit plan investors" or raising the minimum "participation" threshold. However, those measures have repeatedly failed to pass into law.

Foreign Regulation

Foreign regulators – most notably, the United Kingdom and the European Union—regulate the marketing and sale of funds, as well as investigating fund activity. On December 19, 2012, the UK Government passed the Financial Services Act of 2012, abolishing the Financial Services Authority effective April 1, 2013, and creating two new agencies: the Financial Conduct Authority and the Prudential Regulation Authority of the Bank of England. The Financial Conduct Authority and the Prudential Regulation Authority of the Bank of England regulate hedge fund practices in the United Kingdom, publishing "best practice standards" focused on disclosure that some funds have voluntarily adopted. Similarly, the European Union also has adopted standards for certain aspects of the European fund industry through various published directives.

FINRA Considerations

Selling fund interests to investors by third parties requires broker-dealer registration. The Financial Industry Regulatory Authority (FINRA) is a self-regulatory organization of which all SEC-registered broker-dealers who conduct securities activities in the over-the-counter marketplace must be a member. Although FINRA does not regulate funds, it does oversee broker-dealers that market hedge fund investment products. In response, FINRA issued Notice to Members 03-07, where FINRA members were reminded that, when selling funds and funds of funds, certain disclosures and undertakings must be made. These requirements include (1) providing balanced disclosure in promotional material; (2) performing a reasonable basis (due diligence) and customer-specific suitability determinations; (3) supervising those

associated persons selling these funds; and (4) training personnel concerning a fund's features, risks and suitability. See NASD Notice to Members 03-07.

Self-Regulation

There is no actual self-regulation organization for this market. The Managed Funds Association and the Alternative Investment Management Association drafted a framework for a principles-based regulatory system. Further, certain executive agencies previously endorsed a voluntary self-regulatory regime, but there has been no action on this proposal to date. Historically, the SEC has

looked to the help of self-regulatory institutions to assist it in what is an ever-increasing enforcement burden. If the SEC continues to face capacity issues, expect conversations about self-regulation in the fund industry to continue.

Conclusion

In sum, we caution all those who engage in securities transactions with or on behalf of private equity or hedge funds to be prepared for the ensuing scrutiny that will undoubtedly lead to their doorsteps. Fox Rothschild LLP attorneys remain ready to resolve any inquiries and develop policies and procedures to ensure that you are protected.

Section 2: Structural Overview

The Partnership:

[ALPHA] Fund I, LP (the “Partnership”) is a Delaware limited partnership. The principal place of business of the Partnership is located at [_____].

Investment Objectives and Trading Strategies

The Partnership’s objective is to manage a small and mid capitalization long/short equity portfolio focused on generating [above average/superior] market returns over a mid-to-long-term basis. Current income is not a primary investment objective. The Partnership will target companies from [\$35] million to [\$2.5] billion in market capitalization as the Investment Adviser believes these companies typically receive little or no research coverage, yet offer an attractive relationship between enterprise value, growth opportunities and market valuation. The Investment Adviser intends to select securities based primarily on fundamental analysis using its information network and affiliated research personnel to identify and evaluate potential investment opportunities. When feasible, the analysis process may include a detailed review of a company’s financial statements, interviews with management, discussions with suppliers, customers and competitors, and discussions with industry experts. The Investment Adviser believes it can generate superior mid to long-term returns, in part, by relying on_____, a proprietary logarithmic execution and trading strategy owned and licensed from an affiliate. It is the General Partner’s stated intent to cap the overall assets under management of this product to \$_____ million.

INSERT CLAUSE RE DIVERSIFICATION: [The Investment Manager intends to limit the Partnership’s exposure to illiquid or restricted securities to no more than ___percent of the Partnership’s assets (as of the time of purchase). However, the Investment Manager does not otherwise intend to limit the types of securities or other instruments in which the Partnership may invest, the concentration of investments (whether by sector, industry, country, asset class or otherwise) or the amount of leverage employed.]

The Partnership intends to invest in, hold, sell, trade and otherwise deal in Securities, consisting principally, but not solely, of equity and equity-related Securities that are traded publicly in domestic markets. When deemed appropriate by the Investment Adviser, the Partnership may also invest in preferred stocks, private companies, equity partnership interests, convertible Securities, warrants, options, bonds and other fixed-income Securities, foreign Securities, derivatives and money market instruments. The Partnership may also engage in short selling, hedging and other investment strategies. These strategies may involve the use of leverage through margin trading or other mechanisms.

The General Partner: The general partner of the Partnership is [_____] Capital Management, LLC (the “General Partner”), a Delaware limited liability company. The General Partner’s principal office is located at []. The managing member of the General Partner is [_____] (the “Managing Member”). The Managing Member intends to make an initial investment on behalf of the General Partner in the Partnership of \$___.

The Investment Manager: [_____] Capital Management, LLC, a Delaware limited liability company (the “Investment Manager”) is responsible for managing the portfolio of the Partnership, and is also responsible for certain administrative matters. The Investment Manager is not registered with the SEC or with the [state] as its presently only manages the pooled funds of the Partnership; thus, fits within an exemption from registration requirements due to its limited number of clients.

Other Activities of the General Partner and the Investment Manager: Although it does not presently, the Investment Manager may in the future serve as an investment manager to other private investment funds. The General Partner may also serve as a general partner, managing member or investment adviser to other private investment funds. Some or all of these other private investment funds may have investment objectives that are similar or different than those of the Partnership, and may also co-invest with the Partnership on the basis of available capital.

Expenses: The Partnership will reimburse the General Partner for the costs of organizing the Partnership and the initial offering of Partnership Interests (which are not expected to exceed \$_____). The Partnership will be responsible for all of its operating expenses, including, but not limited to, third-party administrator fees, brokerage commissions, all investment-related expenses (e.g., research expenses and travel expenses related to research), legal and accounting expenses, investment expenses such as commissions, custodial fees, bank service fees and other expenses related to the purchase, sale or transmittal of Partnership assets, and overhead expenses of an ordinary and recurring nature. The organizational expenses paid by the Partnership are being amortized over a period of 60 months from the date the Partnership commenced operations.

Each of the General Partner and Investment Adviser is responsible for its own administrative expenses including, but not limited to, office space and salaries of personnel (although the Partnership does intend to sub-lease certain office facilities from an affiliate of the General Partner).

Management Fee: The Partnership will pay the Investment Manager a quarterly management fee (the “Management Fee”) in advance calculated at a rate of 0.50 percent (i.e., 2.0 percent per annum) of the value of each limited partner’s capital account. The Management Fee will not be returned if a Limited Partner withdraws his, her or its investment before the end of a calendar quarter.

Capital Accounts:

A capital account shall be established for the General Partner and for each Limited Partner. Capital Accounts will be adjusted to reflect allocations of the Partnership's net capital appreciation or depreciation, the Management Fee, the Profit Allocation (as defined below), other Partnership expenses, capital contributions, withdrawals and other similar credits and debits during the term of the Partnership (the "Capital Account").

Allocation of Net Profits and Losses; Incentive Allocation to General Partner:

If, with respect to any fiscal year and subject to the loss carryforward provisions below, a Limited Partner has a net profit with respect to his, her or its Capital Account (including realized and unrealized gains and losses), an amount equal to 20 percent of such net profit will be deducted from such Limited Partner's Capital Account as of the end of such fiscal year (the "Profit Allocation") and reallocated to the Capital Account of the General Partner.

No deduction from a Limited Partner's Capital Account with respect to the applicable Profit Allocation will be made in respect of a fiscal year until any net loss previously allocated to the Capital Account of such Limited Partner has been offset by subsequent net profits allocated to the Capital Account of such Limited Partner. Any such loss carryforward, however, will be subject to reduction for withdrawals by such Limited Partner.

Distributions:

The Partnership intends to accumulate profits for reinvestment and does not intend to make periodic distributions.

The Offering:

The Partnership intends to conduct a private offering of a minimum of \$_____ of Partnership Interests (the "Minimum Offering") and a maximum of \$_____ of Partnership Interests (the "Maximum Offering"). The Minimum Offering will be completed on or before [Insert a date certain] and prior to that time, all proceeds will be maintained in an escrow account administered by [insert name of independent escrow agent].

The minimum initial investment is \$_____, [generally, not less than \$500,000 to \$1 million] subject to waiver in the sole discretion of the General Partner. Interests in the Partnership generally will be sold only to persons who are "accredited investors" as defined in Regulation D of the Securities Act of 1933, as amended. The General Partner may admit limited partners, or accept additional capital contributions from existing partners, on the first day of each month and at such other times as the General Partner will, in its sole discretion, permit.

Withdrawals:

Upon at least [60] days' prior written notice to the General Partner, a limited partner may withdraw all or any part of its capital account as of the last day of the month that occurs [generally there is an initial holding period of at least one year] on or after the one-year anniversary of the date of its initial investment in the Partnership and as of the last day of each six-month period thereafter (each a "Withdrawal Date").

In general, upon a limited partner's full withdrawal from the Partnership, at least 90 percent of the amount of the estimated value of the limited partner's capital account as of the withdrawal date will be paid within 30 days after the withdrawal date. The balance, if any, will be paid promptly after the completion of the audit of the Partnership for such year.

Notwithstanding the foregoing, if withdrawal requests are received as of any Withdrawal Date for more than 20 percent of the net asset value of the Partnership as of such Withdrawal Date (the "Withdrawal Limit"), the General Partner may, in its sole discretion (i) satisfy all of such withdrawal requests; or (ii) reduce all withdrawal requests pro rata so that aggregate withdrawals as of such Withdrawal Date equal the Withdrawal Limit. To the extent a limited partner's withdrawal request is reduced, any excess will be paid as of the end of the next Withdrawal Date and each Withdrawal Date thereafter subject to the Withdrawal Limit, until the total amount requested to be withdrawn has been paid in full; provided, however, that such withdrawal request will be given priority over any new withdrawals requested for such subsequent Withdrawal Date.

Reports:

Each limited partner will receive unaudited reports of the performance of the Partnership monthly and audited year-end financial statements annually.

Risk Factors:

An investment in the Partnership involves significant risks and is suitable only for persons who can bear the economic risk of the loss of their entire investment, who have a limited need for liquidity in their investment and who meet the conditions set forth in the Memorandum. There can be no assurances that the Partnership will achieve its investment objective. Investment in the Partnership carries with it the inherent risks associated with investments in securities. Each prospective limited partner should carefully review the Memorandum and the agreements referred to herein before deciding to invest in the Partnership.

Tax Considerations:

The Partnership will not be subject to U.S. federal income tax and each Limited Partner will be required to take into account its distributive share of items of Partnership income, gain, loss and deduction substantially as though such items had been realized directly by such Limited Partner, whether or not actual cash distributions are made to such Limited Partner.

Suitability Standards:

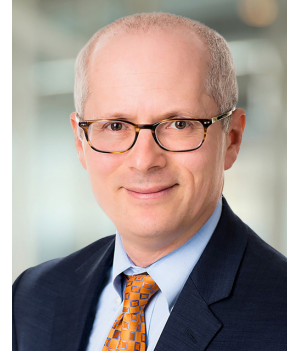
The Partnership may accept subscriptions from pension and profit-sharing plans maintained by U.S. corporations and/or unions, individual retirement accounts and Keogh plans, entities that invest the assets of such accounts or plans and other entities investing plan assets (all such entities are herein referred to as “Benefit Plan Investors”). The General Partner does not anticipate that the Partnership’s assets will be subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), or the prohibited transaction provisions of Section 4975 of the Internal Revenue Code of 1986, as amended (the “Code”), because the General Partner intends to limit the investments in the Partnership by Benefit Plan Investors. Under ERISA and the regulations thereunder, the Partnership’s assets will not be deemed to be plan assets subject to Title I of ERISA or Section 4975 of the Code if less than 25 percent of the value of each class of equity interest of the Partnership is held by Benefit Plan Investors, excluding from this calculation any non-Benefit Plan Investor interests held by the General Partner and certain affiliated persons or entities. The Partnership will not knowingly accept subscriptions for limited partnership interests or permit transfers of limited partnership interests to the extent that such investment or transfer would subject the Partnership’s assets to Title I of ERISA or Section 4975 of the Code. In addition, because the 25 percent limit is determined after every subscription to or withdrawal from the Partnership, the General Partner has the authority to require the withdrawal of all or some of the limited partnership interests held by any Benefit Plan Investor if the continued holding of such interests, in the opinion of the General Partner, could result in the Partnership being subject to Title I of ERISA or Section 4975 of the Code.

ABOUT THE AUTHOR

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Joshua represents major financial services companies in matters throughout the country. He also represents financial advisory companies, individual advisors and counselors in FINRA examinations, enforcement and arbitrations. Joshua has also represented individual brokers on disciplinary matters before FINRA and state securities commissions and has represented companies and individuals in SEC investigations.

Joshua's practice also includes the representation of the premier merchant card processing company in various matters, including class actions, throughout the country.



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