FORMING EXEMPT PRIVATE INVESTMENT FUNDS

February 2023

I. Executive Summary

Just as offers and sales of securities in the U.S. market must be made with a publicly filed registration statement pursuant to section 5 of the U.S. Securities Act of 1933 (the "Securities Act"), which governs the initial issuance of securities unless an exemption from registration is available, companies in the business of investing and managing third parties' money are required to register under the Investment Company Act of 1940 (the "ICA") as "Investment Companies" unless an exemption from ICA registration is available. Moreover, companies offering investment advice usually must register under the Investment Advisers Act of 1940 (the "IAA"). Some investment funds, defined by the Securities and Exchange Commission (the "SEC"), the U.S. securities regulator, as "Private Funds," such as venture capital, private equity and hedge funds, are exempt from ICA registration as Investment Companies. This advisory will review principal corporate, commercial and regulatory (compliance) considerations when forming exempt from ICA registration Private Funds.

II. Private Fund Formation Structuring and Regulatory (Compliance) Issues

a. Investment Company Act of 1940

The ICA provides for the registration, disclosure and ongoing reporting obligations of "Pooled Investment Vehicles," that are defined as Investment Companies, such as retail mutual funds, in which investors purchase equity interests with capital then used by the fund sponsor to make investments for return to the investors. ICA registration, disclosure and reporting is an expensive and time consuming compliance burden.

However, ICA sections 3(c)(1) and 3(c)7 exclude from the ICA definition of an Investment Company that must be registered with the ICA a Pooled Investment Vehicle that is a "Private Fund." Properly structured, Private Funds meeting the sections 3(c)(1) and 3(c)7 exemptions do not have to register as Investment Companies under the ICA, although they are subject to other securities laws and regulations. ICA section 3(c)(1) excludes from Investment Company status Pooled Investment Vehicles with no more than 100 beneficial owners (looking through investing entities to their ultimate beneficial owners), or 250 beneficial owners in the case of a "Qualifying

Venture Capital Fund" (a venture capital fund with no more than $10 million in aggregate capital contributions and uncalled capital commitments). ICA 3(c)7 exempts from Investment Company status Pooled Investment Vehicles limited to investors who are "Qualified Purchasers" (investors meeting ICA financial and sophistication standards, analogous but more stringent than Securities Act Regulation D "Accredited Investor" status; currently $5 million in investments for individuals and $25 million for institutions); there is no limit on the number of Qualified Purchasers, so that a Private Fund exceeding the section 3(c)(1) 100 beneficial owner limit might still qualify under the section 3(c)7 exemption, as long as all beneficial owners were Qualified Purchasers. If a Pooled Investment Vehicle meets either or both the ICA section 3(c)(1) and 3(c)7 standards, it qualifies as a Private Fund and is exempt from ICA registration, disclosure and reporting.

b. Investment Advisers Act of 1940

The IAA requires anyone offering analysis and advice on securities for compensation to register as an investment adviser. General partners and equivalent persons at Private Funds may be required to register, so it is important to understand that while a Private Fund may be exempt from ICA registration, it is not necessarily exempt from IAA registration. The IAA does have an "Exempt Reporting Adviser" exemption pursuant to its section 203(m), which exempts from IAA registration investment advisers who (i) advise solely Private Funds that have less than $150 million in assets under management in the United States; or (ii) advise solely venture capital funds. Even investment advisers meeting those criteria are subject to some reporting requirements, which are filed on SEC Form ADV Part 1A, while non-exempt advisers must make a more extensive Form ADV filing.

The ICA also has a limited "Foreign Private Adviser" exemption that applies only to advisers with no place of business in the United States, fewer than 15 clients in the U.S and investors in Private Funds it advises, less than $25 million in assets under management in the U.S., and does not hold itself out to the public in the U.S. as an investment adviser. If a Foreign Private Adviser meets those criteria, it need not make even an SEC Form ADV Part 1A filing.

c. Securities Act

Offers and sales of securities in the Private Fund are typically made with offering documents containing fund sponsor and investor protections like risk factors, use of proceeds, description of

the securities and other representations, warranties and covenants pursuant to Securities Act Regulation D, Rule 506(b) or 506(c), or to institutional investors like other funds pursuant to section 4(a)(2), all exemptions from the Securities Act section 5 registration requirements (see "Raising Capital through Private Placements: Deal Points," Sections I and V; "Raising Capital through Private Placements Appendix 1 Exemption Chart," both available at **Kurtin PLLC Venture Capital & Private Equity**). Supplemental presentation documents like PowerPoint slide decks are also used.

All three exemptions have unlimited aggregate offering amounts and no restrictions on the fund's ownership, jurisdiction or other status, compared to other Securities Act exemptions that do. Under Rule 506(b), there may be unlimited Accredited Investors, and up to, but no more than, 35 "sophisticated" but non-accredited investors. Under Rule 506(c), all purchasers must be Accredited Investors, without limitation in number. Rule 506(b) and Section 4(a)(2) do not permit general solicitation of investors (advertising to the general public); Rule 506(c) does permit general solicitation. Both Reg. D exemptions require an SEC Form D filing. Breaching the Securities Act exemption requirements can lead to SEC civil and criminal penalties, including investor restitution and barring the fund sponsors from the U.S. capital markets, so it is critical to take the securities laws and regulations seriously.

d. Corporate Formation Structure

Private Funds are typically structured as limited liability companies (LLCs"), limited partnerships ("LPs") or corporations), formed on a standalone basis or in a hierarchical tiered structure such as onshore/offshore master feeder structures to isolate domestic U.S. from non-U.S. investor pools, isolate parent from subsidiary balance sheets, and other purposes (see "Special Purpose Vehicles: Uses and Abuses," also available at **Kurtin PLLC Venture Capital & Private Equity**). The LLC and LP forms permit "pass through" tax treatment, with no taxation at the entity level, and taxes "passed through" to the equity holders.

Critically, it is not enough to form and file a "plain vanilla" LLC, LP or corporation; the legal entity must be structured as an "Investment Ready Vehicle" in its formation documents, with tiered classes of securities, usually common stock or the LLC/LP equivalent for fund sponsors/general partners, and preferred stock or the equivalent for investors/limited partners, containing special preferences like investor liquidation, redemption and other rights. Those fund structuring elements must be tracked into the Securities Act offering documents. In the absence

of proper fund structuring and offering documents, critical regulatory and compliance issues will likely disable the Private Fund, few if any investors will likely invest, and those who do will probably seek redemption of their investments, whether in or out of court. Proper fund structuring, like securities law and regulation compliance, needs to be taken seriously.

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