Appendix C

A Checklist Of Legal And Regulatory Issues For Private Equity Funds Of Funds

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Although many of the issues facing funds of funds are the same as those faced by the typical direct investment private equity fund, other issues present unique challenges and questions.

For example, funds of funds must deal with complex compliance issues under a number of regulatory and tax regimes, including the Securities Act of 1933; the Investment Company Act of 1940; the Investment Advisers Act of 1940; the Employee Retirement Income Security Act of 1974 (ERISA); federal, state and foreign tax laws; and federal, state and foreign open records laws. Many of these issues arise from the multi-tier structure that results when a fund invests in other funds that, in turn, invest in operating companies. The issues may be aggravated by the lack of control the fund of funds typically has over the portfolio funds in which it invests.

A review of the various stages in the life cycle of a private equity fund of funds will illustrate some of the issues.

C.1 Organization And Fund-Raising

A fund of funds cannot sell interests in the fund unless the interests are registered under the Securities Act or are exempt from registration. Typically, funds avoid registration by selling interests only to "accredited investors" that satisfy minimum net worth or income requirements. Limiting the fund's investor base to accredited investors also provides relatively straightforward exemptions under state securities laws.

Similarly, funds of funds must either register under the Investment Company Act, which regulates the mutual fund industry, or qualify for an exemption. Many funds of funds avoid registration by qualifying for the Section 3(c)(7) exemption for funds that have only "qualified purchasers." This enables the fund to admit, for practical purposes, up to 500 investors. However, these funds may market only to investors with substantial investment assets (at least $5 million for individuals or $25 million for entities, with some exceptions). Accordingly, reliance on the Section 3(c)(7) exemption can limit a fund of funds' investor base.

A fund of funds can also avoid registration under the Investment Company Act if it has fewer than 100 investors (the Section 3(c)(1) exemption), which need not be qualified purchasers. Keeping below the 100-investor cap entails fairly complex analysis, as a single investor may count as more than one investor under "look-through" rules. For example, if the investor is a partnership that was formed for the purpose of investing in the fund, then each of its constituent partners must be counted as separate investors in the fund.

Other structures and exceptions available under the Investment Company Act should be explored as well. A fund of funds may be structured as two parallel funds, one exempt under Section 3(c)(7) and one exempt under Section 3(c)(1), to maximize its potential investor base. Also, senior management company personnel may invest as "knowledgeable employees" in a fund that relies on the Section 3(c)(7) exemption, even if they are not qualified purchasers.

As is the case with a regular fund, the fund of funds may consider creating special structures for investors that are sensitive to "unrelated business taxable income" (UBTI) or U.S. trade or business income (ECI). These structures may include special-purpose holding corporations for particular investments or offshore feeder entities or parallel funds for UBTI/ECI-sensitive investors. Because certain of these structures may decrease the after-tax return of U.S. taxable investors and the fund managers and because it may be difficult to obtain assurances that portfolio funds will not generate UBTI or ECI, funds of funds generally should anticipate attracting at least a small amount of UBTI and ECI. In practice, many fund-of-funds managers will not represent to investors that their fund of funds will not realize this type of income.

Changes to U.S. tax laws have made investing directly in a U.S.-based fund less difficult for non-U.S. investors. Nevertheless, such investors may continue to prefer to invest in an offshore entity for other reasons, including tax issues in their home jurisdictions and privacy concerns (including concerns about reporting ECI to U.S. taxation authorities). Many of these concerns are most efficiently addressed through the use of offshore "feeder" entities rather than offshore "parallel" funds.

The fund of funds' general partner and management company are "investment advisers" under the Investment Advisers Act of 1940, as they provide investment advice to the fund as their "client." However, advisers are exempted from registration under the Advisers Act if they have fewer than 15 clients, with each fund that is not a "private fund" counted as one client. As a result, fund-of-funds groups that do not include "private funds" typically avoid Investment Advisers Act registration until the number of their advisory relationships requires them to be registered or until the fund of funds admits employee benefit plans as investors.

Essentially, a "private fund" is a fund (or fund of funds) relying on the Section 3(c)(1) or 3(c)(7) exemption that allows its investors to redeem any portion of their investments within two years of purchase. Under recent Advisers Act rules aimed at hedge fund advisers, a private fund's investment adviser must look through the fund and count the fund's investors as clients for purposes of the fewer-than-15-clients test. For this purpose, the adviser must look through any of the private fund's investors that are funds of funds and count each of the investors in such underlying fund of funds. Further, a non-U.S. private fund's investment adviser must look through a fund of funds (even if non-U.S.) and count as its clients any U.S. residents investing in the fund of funds.

If Investment Advisers Act registration is required, typically the management company registers, thus avoiding separate registration of the fund of funds' general partner. Advisers Act registration exempts the adviser from registration under individual state investment adviser regulations. If the management company is not required to register under the Advisers Act, it should review the regulations in effect in each state where it has an office to ensure that it is exempt from state regulation.

If employee benefit plans subject to ERISA invest in a fund of funds, the assets of the fund will be "plan assets" and the managers will be ERISA fiduciaries, unless benefit plans own less than 25% (by value) of each class of interest in the fund. Legislation has been proposed to raise this limit from 25% to 50%. The "venture capital operating company" (VCOC) exception, which direct investment funds often use to avoid the plan assets designation, is not available to a fund of funds. Accordingly, if a fund of funds has 25% or greater participation by benefit plans, it will hold ERISA plan assets, and the general partner or affiliated management company will be required to register as an investment adviser under the Advisers Act. In addition, ERISA plan investors will have to appoint the registered investment adviser as an "investment manager" under ERISA.

Structuring incentive compensation for a fund's managers when the fund is subject to the Investment Advisers Act or ERISA presents special problems. For example, if a fund that wishes to pay incentive compensation (e.g., carried interest) is relying on the Section 3(c)(1) exemption from registration under the Investment Company Act, the fund must comply with the Investment Advisers Act "qualified client" rules. Under these rules, a fund may charge incentive compensation only to investors who have either a net worth of at least \$1.5 million or \$750,000 invested across one or more funds managed by the same adviser, or who are qualified purchasers. In addition, under certain circumstances, ERISA may impose constraints on the timing of the payment of incentive compensation. Also, incentive fees or distributions that depend on portfolio values must be based on an independent determination of value.

Portfolio funds may require investors, including the fund of funds, to return some portion of distributions received to satisfy the portfolio fund's indemnification obligations (a limited partner clawback). Buyout-focused portfolio funds are particularly likely to have such provisions. Since the liability of investors in a fund of funds generally is limited to their subscriptions, the fund of funds may wish to consider establishing a limited partner clawback of its own. At the very least, the fund of funds should establish internal mechanisms to manage limited partner clawback exposure within the fund.

If a fund of funds' investor base includes individuals or individual retirement accounts (IRAs), it should provide to these investors the privacy notice required under Federal Communications Commission privacy rules. The fund can include this notice in its offering memorandum or subscription agreement, or as a free-standing document. After formation, the fund must again provide a copy of the privacy notice each year.

Private equity funds are responsible for identifying, segregating and freezing assets of organizations that support terrorism. The Department of the Treasury's office of Foreign Asset Control maintains a master list of Specially Designated Nationals and Blocked Persons on its Web site at www.treas.gov (the OFAC List), which is updated periodically. A fund of funds should review its investor base against the OFAC List and monitor the OFAC List for updates. All potential investors in new funds should be checked against the OFAC List as well. Finally, each investor should represent to the fund of funds that no part of its contribution is connected with terrorist or other criminal activities. In addition to protecting the fund, such diligence will enable the fund of funds to make anti-money laundering representations to its prospective portfolio funds, which most will require.

As a fund of funds may have little or no control over the tax structure of investments made by portfolio funds, it is important for the fund of funds to take into consideration and avert (to the extent possible) tax issues that such investments may raise. For instance, U.S. persons who receive income from an investment in a Canadian company through their ownership of a U.S. limited liability company – including fund of funds managers who receive carried interest through a general partner entity that is structured as a limited liability company – will be unable to claim benefits under the U.S.-Canada treaty with respect to that income. Though the Canadian investment could be structured in a manner to eliminate this problem, the fund of funds may have little or no control over the structure. Therefore, unless the fund of funds foregoes investments in portfolio funds that may invest in Canada, managers should structure the fund of funds so that they receive carried interest through a limited partnership rather than a limited liability company.

C.2 Acquisition Of Interests In Portfolio Funds

In the case of direct purchases of newly issued interests in portfolio funds, a fund of funds can attempt to negotiate special provisions to protect its investors. For example, the fund of funds may be able to obtain some protection against the portfolio fund generating UBTI or ECI. However, the more sought-after a portfolio fund is, the less likely it will be to agree to meaningful protections.

Many portfolio funds will allow funds of funds to elect special treatment reserved for tax-exempt investors and non-U.S. investors, if the fund of funds itself has these types of investors. The special treatment may include using "blocker corporations" for investments that would otherwise generate UBTI or ECI, or other investment structures. A fund of funds should not make any such election without first considering the potential tax and economic consequences to its other investors (e.g., U.S. taxable investors). In fact, even certain tax-exempt and non-U.S. investors of the fund of funds may not wish to participate in certain of these special structures.

In the case of secondary purchases of portfolio funds, the fund of funds will not be purchasing interests directly from the portfolio fund. In some situations, however, the fund of funds may seek representations, or even amendments of governing documents, from the portfolio fund. In any event, the general partner or other manager of the portfolio fund ordinarily will be required to consent to the transfers of the interests in question. Due to increasing tax and regulatory concerns, obtaining the necessary consents to transfers of portfolio fund interests is no longer a mere formality.

Portfolio funds also typically rely on either the Section 3(c)(7) exemption or Section 3(c)(1) exemption from the Investment Company Act registration requirements. If a portfolio fund relies on the Section 3(c)(7) exemption, then the fund of funds must be a qualified purchaser in its own right (either by having at least $25 million in investor commitments or limiting its investor base to qualified purchasers). If the portfolio fund is relying on the Section 3(c)(1) exemption, a fund of funds probably will be limited to investing less than 10% of the portfolio fund's committed capital. Otherwise, the fund of funds could, under the look-through rules, cause the portfolio fund to have more than 100 investors and lose the benefit of its Section 3(c)(1) exemption.

If the fund of funds is deemed to hold the plan assets of ERISA plans, its investment in a portfolio fund could cause the portfolio fund to lose its exemption from plan assets treatment. This would happen if the portfolio fund has relied on having less than 25% participation by benefit plan investors and the fund of fund investment takes the portfolio fund over that threshold.

If a fund of funds holds ERISA plan assets, the general partner must avoid ERISA-prohibited transactions. For example, transactions between the fund of funds and entities that are service providers to investing ERISA plans, either directly or through affiliates, could be prohibited. This problem is alleviated to a large extent if the manager of the fund of funds can qualify as a "qualified professional asset manager." This exemption, however, does not extend to transactions with affiliates of the manager, and those would continue to be prohibited unless another exemption is available.

Also, to avoid a further delegation of authority over ERISA plan assets, a fund of funds that holds such assets would normally plan to limit its investments to interests in portfolio funds that have an exemption from plan asset status, either as a venture capital operating company or as a fund that less than 25% participation by benefit plan investors.

Investors that are instrumentalities of federal, state or local governments (such as public universities or government pension plans), and increasingly foreign governments, are often subject to Freedom of Information Act (FOIA) statutes, which can be used to compel such entities to release information to the public. This includes information about the private equity funds in which they invest. As a result, most portfolio fund partnership agreements contain rigorous confidentiality provisions. A fund of funds should incorporate similar provisions in its own governing agreement, which should include a right to withhold or demand the return of confidential information from investors. A few of the most sought-after portfolio funds have even refused to admit investors who are subject to FOIA statutes. To avoid the risk of being shut out of such funds, a fund of funds should consider what additional protections could be put into place to protect confidential information, such as restricting the information provided to such investors.

C.3 Operations And Income

Unless a portfolio fund has made a Section 754 tax election or is otherwise subject to mandatory tax basis adjustment rules, a fund of funds that has made a secondary purchase of an interest in the portfolio fund may be unable to offset a portion of its purchase price against gains when investment securities are sold. As a result, taxable partners in the fund of funds will recognize more gain than if the election were in effect. Funds of funds can request that portfolio funds make a Section 754 election, but there is no assurance that the request will be granted given, among other reasons, the administrative burden to portfolio funds that results.

If a portfolio fund has elected status as an "electing investment partnership," a fund of funds that has made a secondary purchase in the portfolio fund generally will have gross losses allocated to it by the portfolio fund disallowed for federal income tax purposes up to the amount of loss recognized by the seller of the portfolio fund interest.

Managing distributions of securities in kind that are received by the fund of funds can be a major undertaking. Often, a smaller fund-of-funds organization will engage the services of an outside service provider.

The fund of funds may have difficulty obtaining timely financial and tax reports from portfolio funds. This puts pressure on the fund of funds' ability to produce its own reports in a timely fashion. For example, a fund of funds could face considerable pressure to produce its own tax reports for its own investors as soon as possible after year-end. Accordingly, when negotiating portfolio fund terms, a fund of funds should seek to require its portfolio funds to produce reports within a specific time frame.

C.4 Dispositions Of Investments And Windup Of The Fund

The usually difficult task of disposing of the last securities in a private equity portfolio is likely to be even more difficult for a fund of funds, since the problem is multiplied by the number of portfolio funds, each controlling its own liquidation strategy and timetable. Portfolio funds that are winding down often may distribute illiquid portfolio company securities for which there is no market and which the fund of funds' investors may not want or know what to do with. Also, since a fund of funds may acquire interests in portfolio funds that are in a late stage of operation, the process of winding down at the portfolio fund level could begin to impact the fund of funds very soon into its investment period.

Given the important role played by funds of funds in providing a diversified investment opportunity in the private equity asset category and in providing liquidity for existing private equity investors, the regulatory and tax hurdles faced by these funds should be a matter of concern to everyone in the industry. Interested parties continue to propose streamlining the regulatory complexity that funds of funds face. However, such reforms are often slow to be adopted, particularly in the post-Enron landscape of securities regulation. Accordingly, the organization and operation of funds of funds will continue to raise difficult issues that require creative solutions.

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