Distributing private equity funds to US investors

By Geoffrey Kenyon and Martin Carmichael
of Goodwin Procter LLP

First published in a supplement to *International Financial Law Review*
January 2002

About the authors

United States

MARTIN CARMICHAEL
Goodwin Procter LLP

Martin Carmichael is a partner in the corporate department of Goodwin Procter, where he concentrates in the area of corporate and securities law. Mr Carmichael's general corporate law experience includes representing public and private companies involved in a variety of industries, including asset management, manufacturing and high technology. His clients include issuers, underwriters, placement agents and investors in public offerings and private placements of equity and debt. He also represents private equity fund sponsors in the formation of new funds and in their portfolio investments. Mr Carmichael has extensive experience in representing pension funds and other institutions investing in private equity funds, and in secondary sales of such investments. Mr Carmichael's practice includes a broad range of transnational legal matters, including the formation of major joint ventures involving US clients and non-US strategic partners, and representing overseas clients in transactions in the US and various international financing transactions.

Mr Carmichael received his law degree from Stanford Law School, where he served as articles editor of the Stanford Law Review.

GEOFFREY KENYON
Goodwin Procter LLP

Geoff Kenyon is a partner in the corporate department of Goodwin Procter, where he focuses his practice on the investment management industry. Working with major investment managers and other financial institutions and with institutional investors, he has extensive experience with all sectors of the US domestic market, including private equity funds and hedge funds. Mr Kenyon's practice has a significant international component. He has worked with funds organized in a variety of offshore domiciles and has significant experience with funds offered to the European, Asian and Latin American markets. Mr Kenyon also advises numerous non-US investment managers with respect to their US activities. He was the author of two no-action letters through which the Securities and Exchange Commission provided comprehensive guidance for the sponsors of non-US funds seeking to offer shares in the US.

Mr Kenyon received his law degree from Columbia University School of Law, where he was a Harlan Fiske Stone Scholar. He is a frequent speaker at industry conferences and the author of articles on issues affecting the global mutual funds industry.

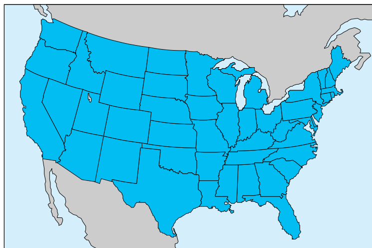
JOHN LECLAIRE

Goodwin Procter LLP

John LeClaire is a partner and co-chair of Goodwin Procter's private equity group. His practice focuses on both private equity transactions and relationships with emerging growth companies. Mr LeClaire's private equity work includes leveraged recapitalizations, buyouts and minority investments, both in later stage situations and earlier stage ventures, for leading private equity firms throughout the country. He also specializes in the representation of emerging growth companies in sectors such as technology and information services, health care, financial services and consumer products. Mr LeClaire's work with these companies focuses on strategic counsel; mergers and acquisitions, including roll-up programmes; IPOs and other financing transactions; equity and executive compensation programmes for senior executives; and going-private transactions. Other private equity work has involved the creation of collective investment vehicles for institutional investors, including the establishment of investment initiatives in Latin America, China and Russia.

Mr LeClaire received his law degree (magna cum laude) from Boston University School of Law. Recent articles by Mr LeClaire have been featured in Venture Capital Journal, Private Equity Analysts' Year 2000 Guide to Corporate Investors and Mass High Tech News.

Distributing private equity funds to US investors



By Geoffrey Kenyon and Martin Carmichael of Goodwin Procter LLP

US institutions and high net-worth investors are seeking opportunities to invest in private equity funds outside of the US. However, many non-US fund sponsors consider the US market inaccessible, protected by significant regulatory barriers. In reality, the securities, tax and other legal issues are quite manageable.

SECURITIES REGISTRATION

Federal registration

Much has been written about the legal obstacles facing non-US funds seeking to enter the US market. While significant obstacles remain for funds that seek to sell shares to the retail market, these obstacles generally do not apply to private placements made to institutions and other sophisticated investors.

Under the federal securities laws, a non-US fund may offer and sell interests to US investors without registration, provided that it does not make a public offering in the US and it places certain limits on the number and type of its US investors. These limits require that the fund have no more than 100 US investors or that all of its US investors be "qualified purchasers". In general, individuals with investment portfolios of $5 million or more and institutions with investment portfolios of $25 million or more are "qualified purchasers".

A typical private equity fund offering (characterized by offers to a small number of sophisticated investors) is comfortably outside the scope of the term "public offering", provided that the sponsor avoids any form of general solicitation or advertising. A fund sponsor must avoid publicity regarding the fund during the offering period, including articles or advertisements in institutional trade publications. The sponsor should also take care that no website describing or otherwise promoting the fund is accessible to the general public. Individual state securities ("Blue Sky") laws, once a substantial impediment to any fund offering, are no longer the problem that they once were. As a practical matter, most private equity funds are able to offer placement without being subject to substantive review at state level.

If a fund makes offers only to sophisticated investors and qualifies for an exception from registration as described above, it is not required to make any specific disclosures to prospective investors. Nonetheless, most funds do employ an offering memorandum as part of their marketing efforts. Although in certain ➨

instances the antifraud provisions of the US securities laws would enable an aggrieved US investor to bring an action in US courts based on alleged errors or omissions in disclosure, suits by US institutions against the sponsors of private equity funds are extremely rare.

Registration as an investment adviser

Fund sponsors, like others who provide securities investment advice, are generally required to register with the Securities and Exchange Commission (SEC). However, a non-US firm is generally exempt from registration as an investment adviser if it furnishes advice to fewer than 15 clients and does not hold itself out as an investment adviser to the public in the US. A private equity fund would normally be regarded as a single client for purposes of this test, even it had numerous US investors. Whether a firm is holding itself out to the public as an investment manager is very fact-specific. Firms seeking to rely on this exception should take care in the manner that they present themselves in the US, particularly in the media and in unrestricted websites.

While an exemption from registration will be available in many circumstances, it is worth noting that many non-US institutions are now registered with the SEC as investment advisers. A decade or more ago, registration imposed significant limitations on a non-US institution's activities outside of the US. This problem has now been largely eliminated as a result of certain interpretative letters issued by the SEC. In the same vein, previous limitations on performance fee arrangements have been substantially reduced. Performance fee arrangements with clients who are resident outside of the US are no longer covered by the Investment Advisers Act of 1940 and SEC rules give an investment adviser wide latitude to structure fee arrangements with US investors that have a net worth of at least $1.5 million or have at least $750,000 under the management of the investment adviser.

Registration as a broker-dealer

Under US federal law, it is generally unlawful to attempt to induce the purchase or sale of any security unless one is registered as a broker-dealer. This obligation has been applied to non-US persons when they engage in any regulated conduct within the US, or if their offshore activities have substantial effects on US markets. Virtually all of the individual states have comparable requirements. For these reasons, it is generally desirable to interpose a US-registered broker-dealer between a non-US fund and its prospective investors.

When a registered broker-dealer is not available, sponsors often take the position that shares of the non-US fund are being marketed by the fund itself, as issuer of the securities and, accordingly, that broker-dealer registration is not required. A safe harbour exemption is available for offers by "associated persons" of the fund, subject to satisfaction of various conditions, including the identity of the prospective investors, the frequency with which the associated persons participate in offerings of securities and the nature of the associated persons' activities. It is not unusual for fund sponsors to take the position that activities outside of the safe harbour are nonetheless exempt. However, this position may be difficult to sustain if an unregistered person receives compensation tied directly or indirectly to sales of interests in the fund.

TAXATION

Partnership taxation

For US investors in private equity funds, domestic and foreign entities are in general equally tax-efficient, provided the fund qualifies as a partnership for US tax purposes. The special tax rules which disfavour offshore structures, including the "passive foreign investment company" and "controlled foreign corporation" regimes apply only to entities that are treated as corporations for US tax purposes.

Both foreign and domestic partnerships are "pass-through" entities. No federal income tax is imposed on a partnership at the entity level and US investors are taxed on their shares of the taxable income of the partnership, not on the money or other assets the partnership distributes to them. The character of the items (eg capital gain or ordinary income) flows through to the partners. In addition, US investors in a fund treated as a partnership may be entitled to the benefits of double tax treaties between the US and the country in which the fund is investing.

Entities on a list of "per se corporations" maintained by the Internal Revenue Service (including public limited companies formed in the UK and Ireland and *sociétés anonymes* formed in Luxembourg and France) are generally not eligible to be treated as partnerships for federal tax purposes. However, a non-US fund that is not a per se corporation may elect to be taxed as a partnership. In addition, if a non-US entity is not a per se corporation, it generally will be

treated as a partnership if at least one owner does not have limited liability, even in the absence of an election.

Notwithstanding these general rules, a fund generally will not be treated as a partnership for US tax purpose if it comes within the definition of a "publicly-traded partnership" because it is traded on an established securities market or on a secondary market, or if it allows frequent redemptions. However, a typical private equity fund is unlikely to fall into this definition.

UBIT

Unrelated Business Income Taxation (UBIT) is a form of taxation that applies to certain income earned by US institutions, such as pension plans, that would otherwise be tax-exempt. UBIT generally applies to investments made by such institutions with borrowed money and may apply when tax-exempt US institutions earn income from "leveraged" (ie geared) funds.

Once again, the US tax treatment depends on whether the fund is treated as a partnership for tax purposes. If the fund is treated as a partnership for US tax purposes, the US tax authorities will generally ascribe any borrowing done by the fund to the fund's investors. To accommodate tax-exempt investors that do no want to incur UBIT, it may be appropriate to create a "feeder" or "parallel" fund in corporate form through which the US tax-exempt entity may invest in the non-US fund, or to use other structures that serve to block UBIT.

ERISA

US corporate pension plans are among the largest and most influential US investors in private equity. All US non-governmental employee benefit plans are subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA). ERISA imposes a comprehensive regulatory regime over persons who serve such plans. Among other things, ERISA establishes the standard of fiduciary care that must be shown by a person making investment decisions for such plans.

Under ERISA's plan assets regulations, absent an exemption, the assets of a fund with one or more ERISA investors are deemed to be "plan assets". If so, the fund itself becomes subject to the substantive provisions of ERISA, including a comprehensive array of operating restrictions, among which are broad prohibitions on transactions with so called "parties in interest" with respect to any of the ERISA investors. Moreover, the fund manager is held to the standards of an ERISA fiduciary. In order to avoid these burdens, most private equity funds that have a significant proportion of ERISA (or non-ERISA benefit plan) investors seek to qualify for the venture capital operating company (VCOC) exception under the plan assets regulation.

If the fund qualifies as a VCOC, only the ERISA plan's investment (eg its limited partnership interest) in the fund (and not any interest in the underlying assets of the fund) will be considered to be plan assets. Consequently, neither the fund nor its manager will be subject to the fiduciary requirements, prohibited transaction rules and penalties, and other provisions of ERISA.

For a fund to qualify as a VCOC it must generally have at least 50% of its assets (measured at cost and disregarding short-term investments) invested in "venture capital investments" on the day it makes its first long term investment) and on at least one day during the designated annual testing period. (In general, an investment will be treated as a venture capital investment if the investee company is primarily engaged directly or through a majority-owned subsidiary or subsidiaries, in the production or sale of a good or service, and if the fund has certain "management rights" with respect to such operating company.) In addition, the fund must actually exercise, and devote substantial resources to the exercise of, its management rights with respect to one or more of its venture capital investments during the annual period. The "management rights" requirement is often satisfied through representation on the board of a portfolio company, but other contractual rights can serve to satisfy the requirement in the absence of a board seat.

Privacy

In late 1999, the US adopted consumer privacy legislation that imposed new obligations upon US-regulated financial institutions. However, these obligations do not apply to private funds organized outside of the US, even when these funds sell their shares to US investors. They also do not apply to foreign investment management firms that are exempt from registration in the US as investment advisers. Finally, they apply only to dealings with natural persons; investors that are legal entities are not regarded as consumers.

Firms subject to these requirements (such as registered investment advisers managing the accounts of high net worth individuals) must disclose the firm's policies and practices with respect to disclosure of non-public personal information. Subject to certain exceptions, no non-public personal information may be shared with non-affiliates unless the regulated firm has given the consumer the opportunity to opt out of the proposed sharing of information. Absent unusual circumstances, registered investment advisers are not precluded from sharing consumer information with their affiliates.