

# 2014 PRIVATE FUND REPORT: A VIEW FROM CALIFORNIA



LOWELL MILKEN INSTITUTE  
FOR BUSINESS LAW AND POLICY



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# PREFACE

The Lowell Milken Institute for Business Law and Policy at UCLA School of Law was created in 2011 to assist the UCLA Law faculty in preparing students to be the future leaders in business law and related careers. The Institute helps faculty develop cutting-edge business law curriculum, creates outstanding co-curricular programs, and provides a forum for the broader business and business law communities for the discussion of current and significant legal and business issues facing California and beyond. A goal of the Institute is to foster an environment for thoughtful conversation and debate of business law issues by a wide-range of stakeholders including business executives, company directors, attorneys, judges, academics, students and the public.

This Report – 2014 Private Fund Report: A View From California – and the companion Private Fund Conference on May 21, 2014 represent the beginning of an anticipated long conversation about private funds with a special emphasis on California-based private funds. The Institute invites your comments and participation in this important conversation.

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# INTRODUCTION: A BRAVE NEW WORLD FOR PRIVATE FUNDS



The purpose of this Report, the first in an anticipated annual series, is to provide an analysis of the intersection of private funds and the law, with a particular focus (where insightful) on the unique perspectives of California fund advisers and investors. The Report is intended to assist lawyers, investment professionals, including the staffs of fund advisers and institutional investors, regulators and other participants in asking better questions about how the law can best protect the legitimate expectations of investors, fund advisers and all of the other direct and indirect participants in the financial system.

Although some of the historic Dodd-Frank<sup>1</sup> reforms remain unimplemented, in recent years the regulatory regime has been transformed for most private equity and hedge funds. The pressing questions now are how

will these new rules be implemented and how will the required information disclosed to government regulators be used. It will take some time for a full assessment of the positive and negative effects of these reforms to be compiled – and much longer before a consensus on some of the more controversial aspects of Dodd-Frank, as applied to private funds, is reached.

Fostering a better understanding of how private funds are actually overseen by regulators and monitored by investors benefits not only the immediate participants in these funds, but also the wider class of savers, pension beneficiaries and voters who have a legitimate interest in ensuring that the financial system is effectively policed. All investment activity involves risk, and legal risk must necessarily be considered alongside the panoply of other risks faced in

## A Brief Note On Terminology

The term “Private Funds” is meant to encompass both hedge funds and private equity funds. The basic characteristics of a hedge fund and a private equity fund are described below.

### Hedge Funds

Hedge funds constitute private pools of capital, supplied by investors that meet certain net worth or sophistication requirements. Hedge funds are not subject to the limitations and restrictions imposed on public funds, such as retail mutual funds in the United States. These funds generally invest in publicly listed securities and derivative instruments based on such securities.

Typically, an adviser to a hedge fund charges the investor both a performance fee, based upon the success of the fund, and an asset-based management fee based upon the amount of the investor's money managed by the fund. Also, the capacity constraints imposed by certain investment strategies mean a limit may exist on how much capital can be employed by a particular hedge fund without negatively impacting its returns and, thereby, the lucrative performance fee accruing to the fund manager. Hedge funds typically conduct their investment activity through a prime broker, which is often a team within a large Wall Street investment bank.

Structurally, hedge funds may be set up either on-shore (i.e. in the market in which the investors are located) or offshore (i.e. in a different market). They make use of either tax transparent entities, such as limited partnerships, or tax exempt entities, such as companies established in jurisdictions where broad tax derogations are possible. Hedge funds are typically open-ended; and therefore, they issue and redeem units or shares directly with investors on a regular basis, based on the net asset value of the units or shares on a particular day.



## INTRODUCTION: A BRAVE NEW WORLD FOR PRIVATE FUNDS (cont.)

the course of making investment decisions. Further, the regulatory regime that has been constructed around the financial markets generally – and around private funds specifically – must constantly evolve to maintain its effectiveness.

As a consequence of the political and economic debate following the 2008 financial crisis and continuing through the 2012 presidential election and beyond, private equity has become

the globalization of private funds has also continued apace in recent years. There are few corners of the globe that are not affected by private equity and hedge fund activity.

Importantly, private funds are not homogeneous. They vary greatly in size, investment strategy, investment style, and a variety of other traits and characteristics. For example, first-time funds face a significantly different reception from investors than the reception accorded

***Investors who were understandably cautious in the aftermath of the financial crisis have become much more willing to consider new managers and innovative approaches.***

an increasingly familiar concept in the broader culture. The names of the largest private equity firms – Blackstone Group, Carlyle Group, TPG (formerly Texas Pacific Group), Apollo Global Management, Kohlberg Kravis and Roberts (KKR) – and hedge fund managers – Bridgewater Associates, Elliott Management and DE Shaw – are known to the general public today to a degree that would have been inconceivable two decades ago.

In 2013, over \$400 billion in new commitments were raised by private equity funds, with overall assets under management estimated at approximately \$3.5 trillion. Last year was also a good year for hedge funds, which saw global assets under management exceed \$2.5 trillion, a \$350 billion increase from the prior year, continuing their evolution away from their traditional investor base of high net worth of individuals and family offices. Moreover,

established funds. Nevertheless, first-time funds are required to comply with an expensive and expanding financial regulatory regime that is largely “one-size-fits-all.” Despite the diversity found in funds, common elements, priorities, and risks can be identified, analyzed, and evaluated. Perhaps nowhere are these commonalities more evident than when discussing the legal and regulatory landscape in which these funds must operate.

As a result of the increased regulation, regulatory compliance has become a significantly higher priority for the senior management of these firms. The principal driver of the commercial terms offered by private funds is the alignment of economic interest between funds, managers and investors. The principal driver of the regulation of private funds, especially since the Dodd-Frank reforms, is the flow of information from the manager to either the

### A Brief Note On Terminology (cont.)

#### Private Equity Funds

Private equity funds are investment vehicles formed to facilitate investments in public and private shares and other securities. Such investments may also include listed companies that, after acquisition by the fund, will be “taken private” and de-listed. Traditionally, these funds have focused on capital appreciation rather than current income. Accordingly, they are usually established as closed-end funds with terms of between ten to fourteen years.

Private equity encompasses a number of different strategies to access investment opportunities in public and private companies. First, venture capital funds invest in young, entrepreneurial companies, frequently focusing on new technologies. Second, buy-out funds purchase significant positions in mature businesses frequently with leverage, with a specified exit period. Third, special situations funds are active in a broad array of debt financing and other investments in distressed or rapidly changing companies.

Two features of private equity funds which distinguish them from hedge funds are the initial commitment made at the launch of the fund to provide up to a certain amount of capital to the fund when required (rather than fully investing a sum of money on the first day), and the fixed life of the fund, ranging from seven to ten years, with all investments having been made during the defined life being realized on or before the termination date. These features derive from their target investments – typically, illiquid stakes in unlisted companies.

## INTRODUCTION: A BRAVE NEW WORLD FOR PRIVATE FUNDS (cont.)



investors or the regulators (e.g., Securities and Exchange Commission, the Commodity Futures Trading Commission) or both. Understanding the role of investors in the ongoing governance structure of private funds is crucial.

In recent years, investors in private funds have become more demanding. The global financial crisis served as an “expensive education” for many investors. More attention is now spent on detailed negotiations prior to investments and increased information flows from the fund to investors over the life of the fund.

Investors who were understandably cautious in the aftermath of the financial crisis have become much more willing to consider new managers and innovative approaches. In addition, the universe of fund investors continues to grow, which has buoyed the industry after the initial uncertainties of 2008-09. The controversial JOBS Act<sup>2</sup> represents an attempt to further expand the pool of potential money flowing into private funds, although to date only

a limited number of managers have taken advantage of it. Meanwhile, the regulatory reforms evidenced in Basel II and III<sup>3</sup>, Solvency II<sup>4</sup>, and the Volcker Rule<sup>5</sup> are each materially changing the framework under which many investors are making their asset allocation decisions.

Public pension plans are among the most important investors in private funds today, although the full political and social impact of their participation has yet to be widely discussed and understood. Important California-based plans such as California Public Employees Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS) are in the frontline of allocations to these funds, often acting as trendsetters willing and able to move market practice in ways that impact the entire industry. Universities are also very active participants in private funds.

Private funds offer their investors the promise of returns that are higher than – and uncorrelated to – their other investments. The fact that,

despite the uncertainties raised in 2008-09, investor confidence in private funds remains high is a significant signal that these funds will continue to have an important role to play in the financial markets and real economies for some time to come. Even with questions raised over the measure of the real returns provided by private equity and hedge funds, their popularity among many investors shows few signs of abating.

In light of these factors, this year's Report is a step toward a wider discussion of how our legal system should best respond to the needs and requirements of fund managers, investors, and the wider society. By asking better questions, we can, in turn, expect better answers.

<sup>1</sup> The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

<sup>2</sup> The Jumpstart Our Business Startups Act of 2012.

<sup>3</sup> The Second and Third Basel Accords include recommendations for international standards on banking regulation issued by the Basel Committee on Banking Supervision.

<sup>4</sup> The Solvency II Directive is a European Union Directive that codifies the European Union's insurance regulation.

<sup>5</sup> The Volcker Rule is found in section 619 of Dodd Frank and, in the simplest terms, places certain restrictions on proprietary trading commercial banks.

# THROUGH A GLASS DARKLY: PUBLIC REPORTING BY INVESTMENT ADVISERS TO PRIVATE FUNDS

## Overview of Findings

In order to gain an understanding of California's position in the private fund industry at year-end 2013, we reviewed the publicly available data on private funds and their advisers collected by the Securities and Exchange Commission (SEC). However, this was not a simple task because the SEC's own presentation of data does not break out private funds from the broader category of funds, including publicly-traded

relative percentage of both public and private fund advisers who make their home in California and the amount of assets under their management.

Historically, a limited number of investment advisers to private funds were required to file SEC Form ADV. Dodd-Frank significantly expanded the universe of investment advisers, including advisers to private funds required to register with the SEC and provide periodic

of Dodd-Frank, many more fund advisers filed SEC Form ADV as part of the registration process. Immediately prior to Dodd-Frank, there were approximately 2,500 hedge fund and other private fund advisers registered with the SEC; as of December 31, 2013, there were 4,153 U.S.-based and international private fund advisers. Some of the information contained in Form ADV filings is available to the public on an aggregated basis on the SEC's Investment Adviser Public Disclosure (IAPD) website.<sup>9</sup>

The data collected and presented by the SEC on the IAPD website does not provide readers with an easily ascertainable snapshot of private funds by themselves. Many advisers of private funds are also part of large fund families that include public funds, such as mutual funds. This reflects the integration of private funds within the traditional investment management industry in recent years. Although each fund family lists information about its private funds separately on Form ADV, the SEC's IAPD website does not break out information concerning private funds from fund families that include mutual funds and other publicly-traded funds.

As explained on the next page, we have used a proxy to estimate the relative size of only private funds managed by entities headquartered in California compared to the size of private funds for the other large geographic centers of private fund activity.

mutual funds. Nevertheless, we were able to make some interesting, albeit limited, conclusions about California's position in the private fund industry. Although California trails the expected geographic leader, New York-New Jersey-Connecticut (NY-NJ-CT),<sup>6</sup> California has a significant market share in terms of the

public reports. Specifically, any advisory firm or person that falls within the definition of "investment adviser" under the Investment Advisers Act<sup>7</sup> and advises funds with at least \$100 million of assets under management is required to register with the SEC, unless it qualifies for an exemption.<sup>8</sup> As a consequence



## THROUGH A GLASS DARKLY: PUBLIC REPORTING BY INVESTMENT ADVISERS TO PRIVATE FUNDS (cont.)

As expected, NY-NJ-CT hosts the largest number of fund adviser headquarters to public and private funds. These NY-NJ-CT advisers, in turn, collectively report the largest relative share of regulatory assets under management (RAUM)<sup>10</sup> as compared to three other major geographic groupings of investment advisers based upon their location – namely, California, Massachusetts, and the remaining 45 States. California has captured a significant market share of RAUM. As of December 31, 2013, California-based fund advisers to public and private funds reported RAUM of \$6.7 trillion, accounting for 19.1% of the total \$35 trillion RAUM by U.S.-based registered funds. California was home to 530 registered advisers, constituting nearly 14% of the total 3,818 registered investment advisers in the United States. These figures understate the size of the total U.S.-based industry as well as California's raw numbers because they do not include U.S.-based investment advisers (including those located in California) exempt from SEC registration.

Determining California's relative position for advisers of private funds only was done through the use of a proxy—comparing the RAUM of the private funds of the top 25 fund families in each of the leading jurisdictions. The top 25 fund families for each of (1) NY-NJ-CT (2), California and (3) Massachusetts were identified, and then the RAUM for only the private funds managed by those top 25 fund manager families was tabulated from the Form ADV filed by each fund family. The results are set forth in Table 1.

**Table 1**

<b>Fund Family Headquarters Location</b>	<b>RAUM for private funds of top 25 fund advisers as of 12/31/13 (in millions)</b>	<b>Percent of RAUM (of Total \$3,530 million)</b>
NY-NJ-CT	\$3,050	86.36%
California	\$290	8.27%
Massachusetts	\$190	5.37%
<b>Total</b>	<b>\$3,530</b>	

### Some Specific Results From Our Review of SEC Form ADV Filings by Fund Advisers to Private and Public Funds

The analyses that follow are based upon the SEC data for fund advisers and include both private funds and public funds. Although these figures are overinclusive because the data includes public funds, these results from the broader fund industry are nonetheless indicative of what is also happening in the realm of private funds.

For purposes of the comparisons and statistical analysis in this Report, we generally analyzed

four groups of registered investment advisers based on the reported geographic location of their headquarters: (1) California; (2) Massachusetts; (3) NY-NJ-CT; and (4) the remaining 45 states.

### Geographic Distribution

California is the second largest state in terms of RAUM by U.S.-based fund advisers. Only NY-NJ-CT, California and Massachusetts exceed 10% of the market as measured by RAUM, as reflected in Table 2.

**Table 2**

<b>State</b>	<b>Total RAUM (in billions)</b>	<b>% of U.S. Total</b>
New York	\$10,000	28.6%
California	\$6,700	19.1%
Massachusetts	\$5,600	15.8%
Pennsylvania	\$2,800	7.9%
Illinois	\$1,900	5.4%
Connecticut	\$1,500	4.2%
New Jersey	\$1,400	4.0%
Texas	\$860	2.5%
Maryland	\$700	1.9%
Georgia	\$500	1.4%
Remaining 40 States	\$3,200	9.2%
<b>Total:</b>	<b>\$35,100</b>	<b>100.0%</b>



## THROUGH A GLASS DARKLY: PUBLIC REPORTING BY INVESTMENT ADVISERS TO PRIVATE FUNDS (cont.)

A list of the top 20 advisers by RAUM is shown in Table 3. California is the home to two of the top three advisers, including PIMCO, the largest U.S.-adviser as measured by RAUM. NY-NJ-CT is home to seven of the top 20 advisers; Massachusetts is headquarters to five. Of course, many of the top 20 advisers are found in more than one jurisdiction, and may have a parent company located in a different jurisdiction.

### Compensation Arrangements

Fund advisers are required to report the types of compensation arrangements that they use by selecting from a list of non-exclusive options provided by the SEC. The data for 2013 showed that fees based upon a percentage of assets under management was the only almost universally used compensation arrangement across geographies, with over 95% of advisers using them in each geographic group. Performance-based fees, the second most common compensation arrangement, were utilized at higher rates by NY-NJ-CT advisers than advisers based elsewhere. California advisers utilized fixed fee structures to a greater extent than NY-NJ-CT advisers. Table 4 compares the use of performance-based fee arrangements and fixed rate fee arrangements.

**Table 3**

Rank	Registered Investment Adviser Name	State	RAUM (in billions)
1.	Pacific Investment Management Company LLC (PIMCO)	CA	\$2,035
2.	Vanguard Group Inc.	PA	\$1,773
3.	Capital Research And Management Company	CA	\$1,157
4.	J.P. Morgan Asset Management	NY	\$774
5.	Wellington Management Company, LLP	MA	\$744
6.	FMR Co., Inc.	MA	\$685
7.	Fidelity Investments Money Management, Inc.	MA	\$630
8.	Blackrock Financial Management, Inc.	NY	\$595
9.	T. Rowe Price Associates, Inc.	MD	\$573
10.	Goldman Sachs Asset Management, L.P.	NY	\$540
11.	Northern Trust Investments, Incorporated	IL	\$529
12.	Prudential Investment Management, Inc.	NJ	\$509
13.	Franklin Advisers, Inc.	CA	\$477
14.	Alliancebernstein L.P.	NY	\$430
15.	SSGA Funds Management, Inc.	MA	\$388
16.	Blackrock Investment Management, LLC	NJ	\$380
17.	Invesco Advisers, Inc.	GA	\$373
18.	Western Asset Management Company	CA	\$364
19.	Strategic Advisers, Inc.	MA	\$327
20.	AIG Asset Management (U.S.), LLC	NY	\$327

**Table 4**

	Advisers Charging Performance-Based Fees	Advisers Charging Fixed Rates
California Advisers	77.7%	20.6%
NY-NJ-CT Advisers	87.8%	13.69%
Mass. Advisers	72.8%	20.0%
45 States Advisers	75.0%	26.5%

## THROUGH A GLASS DARKLY: PUBLIC REPORTING BY INVESTMENT ADVISERS TO PRIVATE FUNDS (cont.)

### Types of Advisory Activities

Fund advisers are required to report on Form ADV the various types of advisory activities in which they engage by selecting from a list of non-exclusive options provided by the SEC. Our analysis of data for 2013 shows that California-based registered investment advisers generally focus on the core activities that would be expected of fund advisers, i.e. portfolio management for pooled investment vehicles and for business and institutional clients, and that they engage in certain ancillary activities at varying, but generally low, rates. This is

A review of the data collected about the specific categories of advisory activities identified by the SEC on Form ADV leads to the following conclusions:

- There was no statistically significant difference among the geographical areas (NY-NJ-CT; California, Massachusetts and the other 45 States) with respect to certain core services. In each of the four geographical areas, more than 86% of fund advisers are involved in portfolio management for pooled investment vehicles (other than investment companies). Likewise, in each of the geographic areas, more

- Approximately 11% of California advisers, 9.2% of Massachusetts advisers and 13.9% of advisers in the 45 States provided financial planning services but only 3.5% of NY-NJ-CT advisers provided such services. Similarly, 36.2% of advisers in California (and similar percentages in Massachusetts and the 45 States) provided portfolio management services for individuals and/or small businesses in 2013, whereas only 22.9% of NY-NJ-CT advisers provided such services, marking a statistically significant difference between NY-NJ-CT advisers and advisers in each of the other geographic groups. However, as noted in the next subsection, NY-NJ-CT advisers offer financial planning services through affiliates at a higher rate than California advisers' use of affiliates for the same service

### Financial Industry Affiliations

Registered investment advisers have affiliates<sup>11</sup> engaged in a variety of financial service activities.

- Broker-dealers, municipal securities dealers, or government securities brokers or dealers: 18.2% of California-based advisers (and similar percentages of advisers in the other state groups) had affiliates of this type in 2013
- Other investment advisers (including financial planners): 40.5% of California-based advisers (and a similar percentage of advisers in the 45 States) had affiliates of this type in 2013; by contrast, a higher number of advisers based in Massachusetts (55.6%) and NY-NJ-CT (56.4%) had affiliates of this type,

broadly consistent with the strategy of fund advisers based in Massachusetts and the 45 States. Interestingly, advisers based in NY-NJ-CT engage in certain ancillary activities at a rate that is statistically lower than that of California-based fund advisers. However, as described in the next sub-section, the NY-NJ-CT advisers may use affiliated entities to perform these activities.

than 40% of advisers offered portfolio management for businesses and institutional clients

- On a percentage basis, fewer of the NY-NJ-CT advisers offer services designed to assist individuals or small businesses such as financial planning and portfolio management for individuals and/or small businesses.



## THROUGH A GLASS DARKLY: PUBLIC REPORTING BY INVESTMENT ADVISERS TO PRIVATE FUNDS (cont.)

marking a statistically significant difference between California advisers on the one hand, and Massachusetts and NY-NJ-CT advisers on the other. Of course, as noted above, a higher percentage of California's advisers provide financial planning services than advisers in NY-NJ-CT

- Commodity pool operator or commodity trading advisers: we find that only 19.1% of California-based advisers (and a statistically similar percentage of advisers in the 45 States) had affiliates of this type in 2013; by contrast, a higher number of advisers based in Massachusetts (34%) and NY-NJ-CT (41.2%) had affiliates of this type, marking a statistically significant difference between California advisers on the one hand, and Massachusetts and NY-NJ-CT advisers on the other. This finding, combined with the finding relating to fund advisers' additional business activities (above), suggests that California-based advisers are exposed to the commodities trading industry (either directly or through affiliates) to a significantly lesser extent than advisers based in NY-NJ-CT. This may indicate an opportunity in the medium term for growth in commodities trading and commodity-oriented funds in California
- Sponsor, general partner, managing partner (or equivalent) of pooled investment vehicles: we find that 63.8% of California-based advisers (and a similar percentage of advisers in the 45 States) had affiliates of this type in 2013; by contrast, a higher number of advisers based in Massachusetts (74.4%) and NY-NJ-CT (80.3%) had affiliates of this type, marking

Table 5 <sup>12</sup>				
Type Of Finding Of Wrongdoing	California Advisers	Mass. Advisers	NY-NJ-CT Advisers	45 States Advisers
Adviser Or Advisory Affiliate Made A False Statement Or Omission	1.0%	4.0%	2.2%	1.5%
Adviser Or Advisory Affiliate Involved In A Violation Of SEC Or CFTC Regulations Or Statutes	3.4%	6.8%	6.2%	3.4%
Entered An Order Against Adviser Or Advisory Affiliate In Connection With Investment-Related Activity	3.2%	6.8%	6.3%	3.5%
Imposed A Civil Money Penalty On, Or Issued A "Cease And Desist" Order To, Adviser Or Advisory Affiliate	3.4%	7.2%	6.5%	3.4%

a statistically significant difference between California advisers on the one hand, and Massachusetts and NY-NJ-CT advisers on the other

### Regulatory Investigations

As part of Form ADV, the SEC asks registered investment advisers to report their disciplinary history and the disciplinary history of their advisory affiliates. Disciplinary history covers enforcement by domestic and foreign courts; the SEC and the Commodities Futures Trading Commission (CFTC); other federal, state and foreign agencies; and self-regulatory organizations, in each case for specified time periods (either ten years or over the lifetime of the adviser).

For federal enforcement by the SEC and the CFTC, California advisers consistently reported lower and statistically different rates of regulatory findings of wrongdoing than advisers based in Massachusetts and NY-NJ-CT.

We observed a similar pattern with respect to findings of wrongdoing as a result of enforcement by the set of regulators grouped by the SEC in the catch-all category of "any other federal regulatory agency [apart from the SEC and the CFTC], any state regulatory agency, or any foreign financial regulatory authority": California advisers generally reported lower rates of violations than advisers based in Massachusetts and NY-NJ-CT. Table 5 reflects the percentages of advisers in each of the geographic areas that reported a specific type of wrongdoing identified on Form ADV.

### A Note on Exempt Reporting Advisers

Our analysis is limited to registered investment advisers (thereby excluding advisers who are relying on an exemption from SEC registration requirements). A subset of exempt advisers, however, is still required to provide some of the information to the SEC on Form ADV. These advisers are generally called Exempt Reporting

## THROUGH A GLASS DARKLY: PUBLIC REPORTING BY INVESTMENT ADVISERS TO PRIVATE FUNDS (cont.)

Advisers (ERAs). ERAs typically include (a) advisers which manage solely private funds with between \$100 million and \$150 million in aggregate RAUM (with private fund advisers managing less than \$100 million being completely exempt from federal registration and private fund advisers managing more than \$150 million subject to full registration), or (b) advisers which manage solely venture capital funds with \$100 million or more in aggregate RAUM (with venture capital fund advisers managing less than \$100 million being completely exempt from federal registration). Put simply, ERAs are generally smaller than the investment advisers required to be fully registered but not small enough to be completely exempt from some reporting to the SEC.

The nature of the SEC's definition of ERAs results in them being a somewhat heterogeneous group that is difficult to analyze. In addition, ERAs are not required to respond to a number of the questions contained in Form ADV (including the question about size/RAUM), which limits the quantity of data available for analysis. Table 6 provides an overview of the percentages of registered investment advisers and ERAs based in each of the geographic groups.

This comparison shows an interesting variation in the nature of the fund adviser industry in California and elsewhere. California and Massachusetts each has a larger relative share of ERAs than each has of registered investment advisers. This observation is perhaps best explained by the fact that California and, to a

Table 6		
	U.S. Registered Investment Advisers	U.S. Exempt Reporting Advisers
NY-NJ-CT	44.5%	33.7%
California	13.8%	23.8%
Massachusetts	6.6%	8.1%
45 States	35.2%	34.4%

***The importance of venture capital on the private funds industry in California should not be underestimated. Although there is a tendency to focus on private equity and hedge funds as the primary asset classes, California's long history as a venture capital hub should be borne in mind when considering the impact of private funds on the wider economy, as well as how the recent regulatory reforms may impact local firms. The venture capital exemption is an important concession for Silicon Valley, Silicon Beach and other centers across the state, but it is not unlimited in its scope and venture firms can be brought into SEC registration as their businesses thrive and expand.***

lesser extent, Massachusetts are focal points for the venture capital industries and advisers to venture capital funds are exempt from registration. Therefore, the importance of venture capital on the private funds industry in California should not be underestimated. Although there is a tendency to focus on private equity and hedge funds as the primary asset classes, California's long history as a venture capital hub should be borne in mind when considering the impact of private funds on the wider economy, as well as how the recent regulatory reforms may impact local firms. The venture capital exemption is an important concession for Silicon Valley, Silicon Beach and other

centers across the state, but it is not unlimited in its scope and venture firms can be brought into SEC registration as their businesses thrive and expand.

<sup>6</sup> Fund advisers located in New York, New Jersey and Connecticut are frequently combined into a single geographic unit by private fund analysts.

<sup>7</sup> The Investment Advisers Act of 1940.

<sup>8</sup> Notably, venture capital funds and funds with \$150 million or less in assets under management remain exempt from registration.

<sup>9</sup> Available at: <http://www.sec.gov/foia/docs/mvafolia.htm>.

<sup>10</sup> Regulatory Assets Under Management or RAUM is a new metric introduced by the SEC in 2012 which requires advisers to report assets managed without deduction of any offsetting liabilities. RAUM is related, but not identical, to the more traditional metric "Assets Under Management" which is no longer used in Form ADV.

<sup>11</sup> The SEC uses the term "related persons" which is defined to include advisory affiliates and persons under common control with the reporting adviser.

<sup>12</sup> Numbers in italics indicate that the difference between the rate for the relevant state or geographic group and the rate for California is not statistically significant.



# A SURVEY OF THE REGULATORY TRANSFORMATION OF THE PRIVATE FUND INDUSTRY AS A RESULT OF DODD-FRANK

The regulatory regime applicable to hedge funds and private equity funds has changed dramatically in the past several years. The transformation has been so stark in some areas that the legal and regulatory landscape is almost unrecognizable when compared to what many fund managers and their investors previously experienced. These regulatory changes were a response to the global financial crisis. The dramatic events of the demise of Bear Sterns, the collapse of Lehman Brothers

funds and private equity funds were also a focus of major reform.

Part of the reform adopted by Congress included changes to the Investor Advisers Act and the passage of Dodd-Frank. For many private funds and their advisers, this reform meant complying for the first time with reporting and disclosure obligations under the federal regulatory scheme. In addition, some private funds and their advisers were required

“regulate the managers, not the fund.”

## Changes to the Investment Adviser Act: The Repeal of Private Adviser Exemption

Dodd-Frank repealed in its entirety the so-called “private adviser exemption” contained in the Investment Advisers Act. Under this exemption, an investment adviser was exempt from federal registration if (i) it had fewer than 15 clients during the preceding 12-month period and (ii) it did not hold itself out to the public as an investment adviser. The absence of any dollar threshold meant that as long as a manager had no more than 14 clients, they could manage billions of dollars in assets and not be subject to SEC registration. Managers of alternative funds historically relied on this exemption in order to avoid registration with the SEC. As a result of Dodd-Frank, many of these advisers must now register with the SEC and adopt appropriate compliance programs.

Under Dodd-Frank, domestic investment advisers with assets under management of \$100 million or more, regardless of the number of clients, must now register with the SEC under the Investment Advisers Act. However, if such advisers manage only “private funds,” the threshold is raised to \$150 million or more of assets. “Private funds” are defined as entities that would be an “investment company” under the Investment Company Act,<sup>13</sup> but for the exceptions provided under Sections 3(c)(1) and

and the grant of commercial banking licenses to Goldman Sachs and Morgan Stanley led many to conclude that the rules for policing Wall Street needed significant reform. The reforms were, of course, not limited to large financial institutions. The regulation of hedge

to disclose to the SEC much more about their business practices and performance than ever before. The new regulations are consistent with the U.S.’s historical approach to regulation—relying on increased disclosure to monitor and police the financial industry thereby seeking to



## A SURVEY OF THE REGULATORY TRANSFORMATION OF THE PRIVATE FUND INDUSTRY AS A RESULT OF DODD-FRANK (cont.)

3(c)(7) of that act. The new dollar thresholds expand the reach of the Investment Advisers Act and significantly reduce the scope of the exception.

Absent an exemption, most private equity and hedge funds would be required to register with the SEC as a retail mutual fund under the Investment Company Act and become subject to a number of constraints that are potentially incompatible with many investment strategies pursued by alternative investment funds. Private equity and hedge funds typically make use of the exemptions provided by Section 3(c)(1) and Section 3(c)(7) of the Investment Company Act to avoid registration.

Section 3(c)(1) is the older of the two exclusions from the definition of “investment company.” The requirements are twofold: the interests in the fund must be privately placed to investors; and the fund must not have in excess of 100 investors. Section 3(c)(7) instead focuses on the status of investors in the fund, rather than their number. The requirements of 3(c)(7) are also twofold: as with Section 3(c)(1), the interests in the fund must be privately placed to investors; and the fund may only have investors who are either “qualified purchasers,” or “knowledgeable employees” of the fund manager.

One result of the changes is that the states’ responsibilities for licensing, monitoring and overseeing investment management firms in their jurisdictions have increased significantly. Prior to the implementation of Dodd-Frank, states were responsible for overseeing and

monitoring firms with less than \$25 million in assets. They must now monitor firms with under \$100 million in assets or \$150 million in the case of firms that advise only private

to allow U.S. investors to have access to international investment talent. The international aspects of private funds cannot be underestimated. While Brussels was a frequent target of allegations

***One result of the changes is that the states’ responsibilities for licensing, monitoring and overseeing investment management firms in their jurisdictions have increased significantly.***

funds. This represents a substantial increase in the responsibilities (and jurisdiction) of state securities departments and law enforcement officials. Unfortunately, states are required to undertake this increased responsibility at a time when many state coffers are empty and budgets are far from balanced. Dodd-Frank did not allocate additional funding to the states to perform their heightened oversight duties, and the SEC is facing its own budgetary problems.

Consistent with historical treatment, “foreign private advisers” continue to be exempt from registration requirements under Dodd-Frank. A “foreign private adviser” is defined as any investment adviser that has no place of business in the U.S. and has fewer than 15 clients and investors domiciled in the U.S. A “foreign private adviser” may not have more than \$25 million in aggregate assets under management attributable to clients in the U.S. Finally, a “foreign private adviser” cannot hold itself out generally to the public in the U.S. as an investment adviser and cannot act as an investment adviser to any registered investment company (also known as mutual fund). This represents an important concession by Congress to continue

that its comprehensive reform of private fund regulation – the Alternative Investment Fund Managers Directive – was about creating “Fortress Europe” that would keep out foreign managers, Washington’s reform efforts allowed foreign managers to have flexibility in accessing U.S. investors.

### **Dodd-Frank’s Increased Disclosure Requirements**

#### **• Form ADV**

In June 2011, the SEC adopted rules to expand disclosure by investment advisers, particularly about the private funds they manage. This expanded disclosure is intended to assist the SEC in fulfilling its increased oversight responsibilities arising under Dodd-Frank. All fund managers subject to regulation are now required to file a Form ADV with the SEC. Form ADV serves to raise the level of disclosure of the once opaque private fund industry.

Under the new requirements, private fund managers filing a Form ADV must provide basic organizational and operational information about each fund they manage. This includes

## A SURVEY OF THE REGULATORY TRANSFORMATION OF THE PRIVATE FUND INDUSTRY AS A RESULT OF DODD-FRANK (cont.)

general information about the size and ownership of the fund. In addition, all funds must now identify and disclose five categories of “gatekeepers” that perform critical roles for advisers and the funds they manage, including the fund’s auditors, prime brokers, custodians, administrators and marketers. In addition, amendments adopted by the SEC seek to illuminate potential conflicts of interest between the funds and advisers by requiring fund advisers to disclose their advisory businesses, the types of clients they advise, their employees, and any other advisory activities performed by the fund manager on behalf of the fund. Finally, fund advisers must disclose any other business practices that may present significant conflicts of interest (such as the use of affiliated brokers, soft dollar arrangements and compensation for client referrals). These new disclosure requirements are intended to facilitate early discovery of fraud and potential misconduct. Our statistical inquiries in the prior section of this Report were made possible by the SEC’s public disclosure of these responses.

### • Form PF

In October 2011, the SEC approved proposed Rule 204(b)-1 under the Investment Advisers Act, which implemented Sections 404 and 406 of Dodd-Frank. The rule mandates reporting on Form PF by certain private fund advisers to assist the Financial Stability Oversight Commission in assessing systemic risk in the U.S. financial system. The rule affects advisers of private equity and hedge funds, as well as other private investment vehicles such as real

estate funds and liquidity funds. Form ADV requires disclosure of information regarding the fund’s basic organizational structure; Form PF goes further – seeking disclosure of sensitive, competitive information.

Under the rule, any investment adviser required to register with the SEC that advises one or more private funds with at least \$150 million in private fund assets under management must file Form PF. The rule places additional requirements on so-called large private fund advisers, which includes advisers managing hedge funds with \$1.5 billion in assets and managers of private equity funds that collectively have at least \$2 billion in assets.

Form PF requires all private fund advisers to annually report on a number of key metrics. These include gross and net asset value of the private fund, detailed performance data, investor concentration, notional value of derivative positions, total fund borrowings, and the fund’s monthly and quarterly performance data. Hedge fund managers are required to report additional information including investment strategies; the percentage of the fund’s assets managed using computer-driven trading algorithms; significant counterparty exposure (including the identity of the counterparty); and the fund’s trading and clearing practices.

A large hedge fund manager overseeing multiple hedge funds must report more detailed information through Form PF to the SEC. A manager of multiple hedge funds must provide aggregate information about the hedge funds it

manages, including aggregate market value of investments held, duration of fixed income portfolio holdings, assets’ interest rate sensitivity, portfolio turnover rate, and geographical breakdown of investments. Large private hedge fund managers are required to file Form PF within 60 days of the end of each fiscal quarter.

A large private equity fund manager must provide different information tailored to the private fund’s investments. Large private equity fund managers must disclose information on the fund’s borrowings and guarantees. They must further disclose the fund’s portfolio companies, including increased disclosure for financial industry portfolio companies, and a breakdown of investments by industry and geography. Large private equity fund advisers who sell their investments are required to file Form PF within 120 days of the end of each fiscal year.

Dodd-Frank requires that the SEC and the CFTC share information reported on Form PF with the Financial Stability Oversight Commission. The information reported on Form PF is obviously sensitive and, if made public, could undermine a fund’s investment strategy and undermine its position in the market. As a result, the SEC has implemented certain safeguards to insure that the information contained in Form PF is provided to other parties on a need-to-know basis and for regulatory purposes. One such measure is that Form PF is exempted from disclosure pursuant to the Freedom of Information Act.

## A SURVEY OF THE REGULATORY TRANSFORMATION OF THE PRIVATE FUND INDUSTRY AS A RESULT OF DODD-FRANK (cont.)

### Larger Trader Tracking – Form 13H

In July 2011, in response to rapid trading of public securities by a number of hedge funds and other aggressive traders, the SEC adopted large trader reporting requirements exercising its authority under Section 13(h) of the Securities and Exchange Act of 1934. The SEC adopted these new regulations in response to technological changes which were altering the trading market. Current technology now permits transactions to trade in milliseconds across multiple venues. The rule facilitates early identification of large traders, thus allowing the SEC to focus its attention on significant market participants and enhancing its ability to quickly and accurately analyze market changes. The need for the SEC to have better access to information is heightened by the fact that large traders, including high-frequency traders, are believed to be playing an increasingly prominent role in the securities markets.

The large trader rule has two primary components. First, it requires large traders to register with the SEC. Second, it imposes recordkeeping, reporting, and limited monitoring requirements on certain registered broker-dealers through whom large traders execute their transactions.

Traders who engage in substantial trading activities will be required to identify themselves to the SEC by filing a Form 13H. A “large trader” is defined as a person whose transactions in exchange-listed securities equal or exceed 2 million shares or \$20 million during any calendar day, or 20 million shares or \$200 million during any calendar month. After Form

13H is filed with the SEC, the large trader is assigned a unique large trader identification number. Traders are then required to provide their identification number to each broker-dealer that they use.

### Performance Fee and Carried Interest Threshold

In July 2010, the SEC raised the threshold for charging a performance fee or “carried interest.” Previously, Rule 205-3 of the Investment Advisers Act allowed an adviser to charge its clients (the fund investors) performance fees when either the client had at least \$750,000 under management with the adviser, or the adviser reasonably believed the client had a net worth of more than \$1.5 million.

inflation adjustments for the dollar thresholds are calculated. In addition, the proposed amendments would exclude from the calculation of net worth the value of an investor’s primary residence. The proposed changes would, however, grandfather in performance fee arrangements that were permissible at the time the adviser and client entered into their advisory contract.

As a result of the increased investment thresholds, a significant number of individual investors who may previously have been eligible to invest in these alternative funds are now excluded. The 20% performance fees and carried interest that are at the foundation of the economics of hedge funds and private equity funds show little movement to accommodate these changes to Rule 205-3. Ultimately, the effect of such rising

***Ultimately, the effect of such rising thresholds may be to exclude more investors from the universe of potential fund participants rather than inducing advisers to retain these investors and forgo their incentives allocations.***

The new rule raises the thresholds at which the fund can charge performance fees to its investors. Now the qualified client must have at least \$1 million under the management of the adviser, or a net worth of more than \$2 million. These thresholds are measured at the time the prospective client enters the advisory contract or purchases the fund interests. Under the new regime the SEC must adjust these thresholds every five years to account for inflation.

The SEC has proposed further amendments to Rule 205-3 that would standardize how

thresholds may be to exclude more investors from the universe of potential fund participants rather than inducing advisers to retain these investors and forgo their incentives allocations.

### Whistleblower

Dodd-Frank created a formal whistleblower program that substantially expanded the SEC’s authority to compensate individuals who provide the SEC with information about violations of the federal securities laws. The program’s goal is to reward individuals who provide the SEC



## A SURVEY OF THE REGULATORY TRANSFORMATION OF THE PRIVATE FUND INDUSTRY AS A RESULT OF DODD-FRANK (cont.)

with tips that lead to successful enforcement actions and thus entice more whistleblowers to come forward. The new program reflects one way the SEC is attempting to overcome its limited staffing and financial resources.

The whistleblower program rewards individuals who act early to expose securities violations and who provide significant evidence that helps the SEC bring successful cases. Prospective whistleblowers must voluntarily provide original information to the SEC. That information must lead to an enforcement action which results in the SEC obtaining monetary sanctions in excess of \$1 million.

In general, information is voluntarily provided if the whistleblower comes forward before the government or a self-regulatory organization directly asks the whistleblower for the information. Original information must be previously unknown to the SEC and based upon the whistleblower's independent knowledge or independent analysis. Several categories of individuals are excluded from the program, including individuals themselves culpable for the violation they are informing upon as well as foreign government officials. Attorneys who might attempt to use information obtained from client engagements to make whistleblower claims are also prohibited from participating in the program.

The SEC is required to pay individuals bounties if they fall within the parameters of the whistleblower program. Payments can range from 10 to 30 percent of the money ultimately collected in the SEC enforcement action.

Dodd-Frank required the SEC to create an Office of the Whistleblower, which handles tips and complaints, and helps the SEC determine the awards for each whistleblower.

In August 2012, the SEC announced that it had a recipient for its first bounty payment under the whistleblower program. The SEC issued an award of \$50,000 to a whistleblower that helped stop a multi-million dollar fraud.

curtails ancillary investment activities of banks and reinstates the boundary line between investment banking and commercial banking that existed until the Glass-Steagall Act was repealed in 1999. The Volcker Rule attempts to prevent banks from proprietary trading, and limits the type of relationships that they may have with private equity and hedge funds. Underlying this rule is the belief that because commercial banks are fundamental to the



Robert Khuzami, Director of the SEC's Division of Enforcement, noted that "had this whistleblower not helped to uncover the full dimensions of the scheme, it is very likely that many more investors would have been victimized."

### Volcker Rule

Finally, no survey of the U.S. government's response to the global financial crisis would be complete without a short discussion of the "Volcker Rule." The rule's namesake Paul Volcker has a long tenure in regulating and directing U.S. financial markets. The "Volcker Rule"

economy, they should be insulated from the higher risks associated with alternative investment vehicles such as private equity and hedge funds. There has been strong opposition to the rule from many quarters of the financial world.

<sup>13</sup> Investment Company Act of 1940

### Conclusion

As the Volcker Rule attempts to draw boundary lines around what investment banks and commercial banks can do, these precautions only re-enforce the position of private equity and hedge funds as separate from the traditional cut-and-thrust of life on Wall Street and in London. However, the entire process of implementing comprehensive reform of financial services regulation has again been shown to be very difficult. The questions that must be addressed in the near future are: first, how will the Dodd-Frank reforms be implemented and enforced on a day-to-day basis, and second, what impact will they have on the structure and operation of the financial markets in the future?

# SEC ENFORCEMENT HITS A CONGRESSIONAL SPEED BUMP?

For the last several years there has been a steady drumbeat by both the SEC and commentators that the SEC was expanding its enforcement activities against investment advisers, including advisers for hedge funds and private equity funds. The call to action began in January 2010 with the creation of the Asset Management Unit (AMU) of the SEC's Enforcement Division. The AMU conducts investigations into investment advisers, investment companies, and private funds. With the AMU the SEC has made it clear that overseeing investment advisers of every stripe is a high priority. Indeed, Bruce Karpati, the AMU's first chief, received the SEC Chairman's Award for Excellence in 2012 for the AMU's work on the Aberrational Performance Inquiry (API).

API uses risk analytics to measure performance data of hedge funds to uncover various types of investment fraud by their managers. The financial industry and its advisers describe API as ushering in a new age of SEC scrutiny into hedge fund performance. Rather than relying upon traditional investigation methods, API emphasizes data mining and powerful analytics to uncover potential fraud.

In 2013, while the SEC had brought more cases against hedge funds than in prior years, its senior officials indicated that the agency's attention was turning toward private equity.<sup>14</sup>

However, as a result of its omnibus budget bill for fiscal 2014, Congress may cause the SEC



to re-evaluate its priorities. In 2013 SEC Chairperson, Mary Jo White, sought a 26% increase in the SEC's annual budget over its 2013 budget. In its budget proposal, the SEC indicated that one of its top priorities for 2014 was to increase the number of investor adviser examinations it handles. Admitting that

Congress, however, limited the overall 2014 budget increase to just 2%, setting a spending allocation for the SEC at \$1.35 billion, a mere \$29 million increase over the SEC's 2013 budget, and \$324 million less than the SEC's budget request. In response, investment adviser oversight

***In 2013, while the SEC had brought more cases against hedge funds than in prior years, its senior officials indicated that the agency's attention was turning towards private equity.<sup>14</sup>***

approximately 40% of registered investment advisers are not examined, the SEC indicated its desire to hire an additional 250 examiners in order to increase its examination rate from 8% of all registered investment advisers to 45-55%.

advocates have suggested legislation by which investment advisers would be charged user fees to provide funds for enhanced examinations of investment advisers.

<sup>14</sup> Bruce Karpati, "Private Equity Enforcement Concerns," Speech delivered at the Private Equity International Conference, New York, N.Y., January 23, 2013.

# THE JOBS ACT AND PRIVATE FUNDS: AN INTRODUCTION TO THE NEW REGIME



## How to Lose by Winning the Lottery

In October 2007, Jason and Eva Hemenway won \$25 million in the Florida Lottery. Mr. Hemenway, age 63 at the time of the award, described himself as a semi-retired “jack-of-all-trades” who mostly worked hauling items in a dump truck. In an interview following the announcement, Mr. Hemenway said he had an “appointment at a bank...to discuss his options as far as investing the money so that he can basically live off the interest. But he said he doesn’t plan to do anything too risky or invest in the stock market.”<sup>16</sup>

The rest of the story is, unhappily, both familiar and predictable. Although the Hemenways contend that they were utterly unsophisticated with respect to financial and investment matters, under federal law, the Hemenways qualified as accredited investors. As a consequence, they were legally eligible to make financial investments not otherwise available to the general public and not subject to SEC review. An investment adviser steered the Hemenways to a hedge fund, and the Hemenways invested \$3 million in two limited partnership interests. Fourteen months later, the Hemenways had lost approximately \$1.2 million of their \$3 million investment and sued to recover their funds alleging false representations and fraud, breach of fiduciary duty, and violation of federal and state securities laws. The defense pointed out repeatedly that the Hemenways were accredited investors and therefore capable of accepting the risk of a hedge fund.

Beginning in 2014, and every four years thereafter, Dodd-Frank requires the SEC to review the “accredited investor” definition in its entirety and to engage in further rulemaking to the extent it deems appropriate. Adding a requirement that an investor, who meets the financial resources test, must also demonstrate a basic level of sophistication and experience in financial matters might reduce the number of stories

After a wait of almost 18 months, the JOBS Act went into effect in September 2013. When President Barack Obama originally signed the law in April 2012, the focus was on undoing many of the impediments to initial public offerings (IPOs) that were the direct consequences of the Sarbanes-Oxley Act.<sup>14</sup> The goal was to significantly revamp the way in which private capital is raised in the U.S., thereby creating jobs and fostering growth.

Fund advisers and their counsel, however, soon began focusing on another group of beneficiaries to the JOBS Act—namely, alternative investment vehicles, such as hedge funds and private equity funds. The JOBS Act has made it easier for these funds to raise money from “accredited investors.” The definition of an accredited investor includes

an individual who earns more than \$200,000 per year or has more than \$1,000,000 in net worth, excluding the value of the family home.

Historically, in general, anyone approaching a prospective investor in connection with privately-placed securities had to have a substantial pre-existing relationship with the investor. The statutory exemption for privately-placed securities was lost if, for example, advertisements or articles were published in a newspaper or magazine, or interviews or notices were broadcast on television or radio. The JOBS Act has drastically changed the landscape. Now private funds seeking to raise capital can approach anyone, using any means of advertising so long as the fund confirms the investor’s status as an accredited investor prior to actual investment.



## THE JOBS ACT AND PRIVATE FUNDS: AN INTRODUCTION TO THE NEW REGIME (cont.)

### General Solicitation

As mandated by the JOBS Act, the SEC adopted rules eliminating the prohibition against general solicitation for the offer and sale of securities conducted under Rule 506 of Regulation D of the Securities Act of 1933, as long as all purchasers are “accredited investors.” Under the new regime, issuers of securities are now able to advertise in the media, solicit through open web sites and conduct general investment seminars, subject to certain verification requirements. Pursuant

There are still unanswered questions about the meaning and application of these factors. How should each individual factor be interpreted? What weight should be given to any particular factor? How will “reasonableness” vary from one set of circumstances to another?

Existing Rule 506 (re-designated as Rule 506(b)) remains available for issuers not wishing to engage in general solicitation. As a result, issuers now have a choice. They may either conduct an offering involving general solicitation under Rule 506(c) or an offering not involving general

### How to Lose by Winning the Lottery (cont.)

like that of the Hemenways who were unsophisticated in financial matters. However, the additional requirement will also restrict access to capital. As a result, one suspects that the Hemenways’ unhappy experience will be repeated by other “wealthy” but nonetheless exploitable individuals.

***Under the new regime, issuers of securities are now able to advertise in the media, solicit through open web sites and conduct general investment seminars, subject to certain verification requirements.***

to new Rule 506(c), the issuer must take “reasonable steps to verify” that purchasers of the issuer’s securities are, in fact, accredited investors. Whether the steps taken are “reasonable” will, in the SEC’s view, be an “objective” determination by the issuer under the facts and circumstances relating to each purchaser and transaction, including, but not limited to, the following:

- The type of accredited investor that the purchaser claims to be
- The amount of information that the issuer has about the purchaser
- The nature of the offering, such as the manner in which the purchaser was solicited to participate in the offering
- The terms of the offering, such as a minimum investment amount

solicitation under Rule 506(b). However, each operates under two very different models for verifying the “accredited investor” status of would-be investors. Rule 506(c) requires taking into account undefined factors to determine accredited investor status; Rule 506(b) continues to apply the reasonable belief test from prior law. This will have practical ramifications for the issuer in terms of the procedures that must be followed when considering each sale of securities.

Importantly, issuers will not be permitted to proceed under both the 506(c) and 506(b) at the same time for the same offering. The use of general solicitation in connection with a 506(c) offering would be inconsistent with an offering made pursuant to Rule 506(b). Further, once a general solicitation has been made under Rule 506(c), an issuer is now precluded from relying

on Rule 506(b) for that same offering. Thus, funds wishing to raise capital without engaging in general solicitations are free to proceed as before. However, if a fund wishes to tap into new sources of investment through advertising, it must also wade into a new and uncertain regulatory scheme.

The SEC rules further amended Form D, which issuers relying on a Regulation D exemption are required to file with the SEC. In order to accommodate the different private placement options, a Form D filer must now explicitly state that they are relying on the new Rule 506(c) exemption.

### Bad Actors

Under new Rule 506(d), an issuer will not be permitted to rely on the Rule 506 exemption from Securities Act registration if the issuer or any other “covered person” has experienced a “disqualifying event.” Rule 506 previously did not impose any bad actor disqualification requirements.

“Covered persons” is defined broadly to include, among others, the issuer; any predecessor of

## THE JOBS ACT AND PRIVATE FUNDS: AN INTRODUCTION TO THE NEW REGIME (cont.)

***Importantly, this prohibition on bad actors applies to all Rule 506 offerings, not just offerings in which an issuer engages in general solicitation pursuant to new Rule 506(c).***

the issuer or an affiliated issuer; any director, executive officer, other officer participating in the offering; any general partner or managing member of the issuer; any beneficial owner of 20% or more of the issuer's outstanding voting equity securities, calculated on the basis of voting power; and any investment manager of an issuer that is a pooled investment fund.

A “disqualifying event” occurs when a covered person has been convicted within the last ten years before the sale of any felony or misdemeanor (a) in connection with the purchase or sale of any security, (b) involving the making of any false filing with the SEC, or (c) arising out of the conduct of the business of an underwriter, broker, dealer, municipal securities dealer, investment adviser or paid solicitor of purchasers of securities. In addition, being subject to various SEC orders or orders from state securities commissions would also disqualify a covered person from conducting a Rule 506 private placement.

Importantly, this prohibition on bad actors applies to all Rule 506 offerings, not just offerings in which an issuer engages in general solicitation pursuant to new Rule 506(c). However, if an offering is disqualified under Rule 506(d), the offering could still be conducted pursuant to another exemption, such as, for example, Section 4(a)(2) of the Securities Act.

### **“Fend for Themselves”**

The magnitude of change as a result of the JOBS Act cannot be overestimated. The prohibition against general solicitation sat at the core of the U.S. private placement regime for many decades. Importantly, however, the objective dollar thresholds at the heart of the accredited investor definition remain the meter stick for participation in private placements.

Underlying the dollar thresholds for accredited investors is the belief that they can “fend for

themselves.” Some critics, however, have argued that the fact that so many accredited investors fell victim to Bernard Madoff's infamous Ponzi scheme is evidence that, in fact, such investors are either unable or unwilling to protect themselves. Nevertheless, post-JOBS Act, responsibility for investment decisions is placed squarely in the hands of investors. As the SEC attempts to balance the needs of investors and fundraisers, while simultaneously working diligently to mitigate against the risks of fraud and criminal activity, investors find themselves in as much need of caution as of foresight. As a result of the JOBS Act, those who previously had the means but not the access to private funds may now be presented with a whole new world of investment opportunities. Investors sifting through the potential investments will need to bear in mind that the advertised funds are potentially those opportunities that many others have passed over.

<sup>15</sup> The Sarbanes-Oxley Act of 2002.

<sup>16</sup> “Chieftland lottery winner takes lump-sum amount,” <http://www.gainesville.com/article/20071017/NEWS/710170335?p=2&tc=pg#gsc.tab=0>

# SILENT PARTNERS NO MORE: THE ROLE OF INVESTORS IN PRIVATE FUNDS

To fully understand private funds, it is just as important to understand the motivations and priorities of the investors as it is to analyze the more prominent role played by fund managers.

Private funds have traditionally been the domain of high net worth individuals, in the case of hedge funds, and institutional investors, in the case of private equity and real estate funds. Institutional investors include public and private pension funds, endowments, foundations, insurance companies, banks, financial

contributed to more sophisticated business practices, increased transparency and overall professionalization. Attracting institutional investors requires significant investment in business process, together with increased legal and compliance costs.

Many people inexperienced with private funds are often quite surprised when they first learn that the retirement plans of teachers, police officers and sanitation workers serve as the foundation for these financial high-fliers.

## ***Attracting institutional investors requires significant investment in business process, together with increased legal and compliance costs.***

institutions, universities and corporations. High net worth individuals have either invested in hedge funds directly or indirectly, through either family offices or private banks.

Recently, institutional investments in hedge funds have accelerated rapidly and are now recognized by the industry and its regulators as a principal driver for future growth. In the last decade, hedge funds have multiplied in total assets under management driven primarily by large institutional investors who now provide over half of the money sitting in hedge funds. This is a marked change from the early days of hedge funds, when almost all of the money came from high net worth individuals. This change in the investor base for hedge funds has

What brings these two very different worlds together is central to understanding the key dynamics in the industry and the growth of these funds in recent years.

Simply put, U.S. public pension plans are in a race against time. It has been estimated that unfunded pension liabilities add up to more than \$2.5 trillion. As a result, these plans are turning to private equity and hedge funds as a source for above-market returns they need in order to close the funding gap.

Many of these public pension plans are seeking to provide retirement benefits to enormous groups of beneficiaries. CalPERS, for example, manages retirement benefits for 1.6 million

Californians and has over \$200 billion to invest. The City of New York has five separate pension funds for over 500,000 beneficiaries, with assets of approximately \$120 billion. The plans are estimated to pay \$400 million each year to various investment advisers.

As public pension funds are being asked to achieve increasingly higher investment returns in order to deliver retirement benefits to their beneficiaries, these retirement plans are being forced to allocate more of their money to riskier and riskier funds. Conventional wisdom holds that in the U.S. approximately two-thirds of the money in private equity and venture capital funds comes from tax-exempt investors such as pension funds and university endowments. Institutional investors across Britain, Europe and other leading industrialized countries are also facing similar shortfalls and similar drives for higher and higher returns. Although U.S. public pension plans have always been at the forefront of investing in private equity and hedge funds, many of the challenges they are facing in this area apply equally to institutional investors around the world.

Typically, pension plans that invest in private funds are defined benefit plans, rather than defined contribution plans. The distinction between these two plans is very important. Defined benefit plans, which provide set payments to recipients at the end of their working life, are better suited to the liquidity

## SILENT PARTNERS NO MORE: THE ROLE OF INVESTORS IN PRIVATE FUNDS (cont.)

demands of these funds. By definition, a defined contribution plan cannot have a pension liability deficit that needs to be made up. What is there at the time of retirement is all that is there. By contrast, a defined benefit plan has an obligation to pay beneficiaries a predetermined amount and if the assets in the plan are not sufficient, higher returns will

Dhabi government, and invests in substantial assets across a number of asset classes, including private equity and hedge funds, as well as listed equities, fixed income and real estate. The Kuwait Investment Authority, the Government of Singapore Investment Corporation and the China Investment Corporation are also active investors.

attention on understanding how the funds operate and locating areas of particular risk. Investors contemplating allocations to these asset classes today are increasingly allocating more and more time to understanding the risks each fund poses.

The underlying dynamic between fund managers and fund investors is crucial to any attempt to understand how private equity and hedge funds operate in the world and what drives decision-making at either end. Far too often, however, the role of investors in these structures is ignored or minimized. Perhaps this omission stems from simple ignorance, but there is a risk that these omissions are made purposefully as a way of providing a narrative about the nature of private equity and hedge funds that lends itself more readily to certain partisan political viewpoints.

When a public pension plan invests in a private equity fund or a hedge fund, the retirement savings of millions of government employees are often handed over to a small handful of millionaire (or billionaire) investment professionals who stand to earn staggering sums of money in return for generating significant returns for these working class beneficiaries. Pension funds are in desperate need of high yields on their investment portfolios, and they are willing to pay to get it.

Given this significant flow of money from U.S. public pension plans to private funds, how much influence do the trustees public pension plans have on fund managers and their decision-making? This question goes to the heart of the

need to be earned to close the deficit. As pension assets continue to shift from defined benefit to defined contribution in the U.S., fund managers are hoping that pension plans in other markets, such as the United Kingdom and Europe, will allocate to private funds to make up for the loss of assets.

Importantly, a growing segment of private equity and hedge fund investors are the sovereign wealth funds. These entities manage the great pools of wealth that can be accumulated by states that are monetizing their natural resources. For example, the Abu Dhabi Investment Authority (ADIA) is wholly owned by the Abu

The decision to invest in alternatives is only the first of a long series of questions that necessarily follow from that initial allocation. There are literally thousands to choose from (with new funds being launched each and every month), so it is not a simple process. Several factors drive a prospective investor's decision to allocate money to a particular private equity or hedge fund manager. These include their assessment of the manager's track record and prior experience, the particular investment strategy the manager proposes to follow, and the organizational infrastructure supporting the manager's business. Importantly, since 2008, investors have focused more





## SILENT PARTNERS NO MORE: THE ROLE OF INVESTORS IN PRIVATE FUNDS (cont.)

structures used for these funds, as well as raising several important questions. For example, what recourse does a public pension fund, or any investor in a private equity fund or a hedge fund, have if the fund loses money? In practice, only limited remedies will usually be available to a fund investor facing large losses.

Being a pension fund trustee who invests in private equity and hedge funds is not a job for the faint-hearted. By their very nature, investments in private funds may demand a disproportionate amount of time and resources of an investor, both in making an initial allocation of the fund's assets and in monitoring the allocations going forward. The answer to this demand can be either an increase in internal personnel and capabilities or investing by way of fund-of-funds or other multi-strategy products. Neither approach, however, is without cost.

Fund-of-funds, for example, can play a crucial role in providing full-time oversight of an allocation to private funds. Such service includes sourcing funds with available capacity, monitoring their performance over time, and when appropriate, realizing the profits from the fund and reallocating. Unfortunately, the dire fate of several fund-of-funds involved in the Bernard Madoff debacle, which were sued by disgruntled

investors when it turned out they were simply “feeders” into his Ponzi scheme, clearly demonstrates they are not always a fool-proof solution that can guarantee the desired results.

Nowhere are the principles of supply and demand more evidently in operation than in

Even during the best of times, the process of investing in a fund can be a time-consuming ordeal for all parties involved. Due diligence demands have been steadily rising since 2008 as institutional investors have become better educated about what separates successful funds from unsuccessful funds. Investors are asking more and more sophisticated questions

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the processes of securing a prospective investor's participation in a new private equity or hedge fund. During a particular fundraising cycle, it is not uncommon to see a very small number of elite fund managers facing massive over-subscription, while a significant number of others have difficulties obtaining money sufficient to even launch their funds. The practical implications of this tendency for investors to adopt a “herd mentality” around established brand names, influenced in part by subjective factors such as perceived exclusivity, arguably grants too many fund managers the higher ground when it comes to negotiating the commercial and legal details surrounding the actual investment in the fund.

about how fund managers create value for their funds.

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An on-going debate centers on the relative balance of power between investors and fund managers at any given time. Principally, the focus has been on objective economic factors such as the ability of investors to demand lower fees. Increasingly, however, issues of fund governance and on-going oversight of the fund managers are arising when relative negotiating leverage allows.

# PRIVATE FUND LITIGATION: FUNDS MAKE HEADLINES



Even prior to Dodd-Frank and the regulatory transformation of the private fund industry, private funds have always been subject to being hauled into court by prosecutors, regulators and, of course, disappointed investors. The U.S. financial services industry provides a robust environment for high-stakes, high publicity civil, criminal and regulatory proceedings. As active participants in the financial markets, private funds are not strangers to litigation and enforcement proceedings.<sup>17</sup> Private funds, regardless of whether they are classified as private equity or hedge funds, solicit, invest, and manage the money of their investors. As a consequence, private funds sometimes find themselves in litigation with disgruntled investors who are upset with returns that fell short of their expectations.

While garden variety “investor versus fund manager” lawsuits make up the bulk of private fund litigation, some private funds found themselves in court cases discussed “above the fold” in the business press. The following summary highlights several of the more important litigation stories for private funds in 2013.

## **U.S. v. SAC Capital Management Companies**

SAC Capital Management Companies (SAC) is a group of funds founded by Steven A. Cohen, who was described by *BusinessWeek* in 2003 as the “The Most Powerful Trader on Wall Street You’ve Never Heard Of.”<sup>18</sup> However, while SAC racked up outsized returns each year regardless of the overall market performance,<sup>19</sup> the U.S. Attorney for the Southern District of New York

(Manhattan) conducted a multi-year investigation into SAC. On November 4, 2013, SAC entered into a guilty plea agreement to resolve a five count indictment charging SAC with securities fraud and wire fraud in connection with an insider trading scheme.<sup>20</sup> The indictment alleged wide-ranging criminal activity at the highest levels of SAC, including trading on insider information “committed by numerous employees, occurring over the span of more than a decade, and involving the securities of more than 20 publicly-traded companies across multiple sectors of the economy” gathered from “networks of public company insiders” recruited by SAC. A companion forfeiture action seeking, among other things, civil penalties for money laundering was also resolved by the plea agreement.

The plea agreement included a \$1.8 billion financial penalty and an agreement that SAC would no longer accept investor funds and would terminate operations as an investment adviser. SAC received a \$616 million credit against the financial penalty as a result of a separate agreement with the SEC to settle insider trading charges. The district court accepted the plea agreement on April 10, 2014.

The U.S. Attorney also filed criminal charges against eight individual employees of SAC. Six have pleaded guilty to securities fraud. Former portfolio manager Michael Steinberg was convicted of five counts of securities fraud and conspiracy in December 2013. An eighth

## PRIVATE FUND LITIGATION: FUNDS MAKE HEADLINES (cont.)

employee, former portfolio manager Mathew Martoma, was convicted by a federal jury in Manhattan on February 6, 2014. A new indictment was announced in March 2014 against a ninth employee.

### Lessons Learned from SAC

The SAC cases provide lessons in numerous areas. First, the U.S. Attorney in Manhattan has made the investigation of insider trading a priority: “The scope of the insider trading problem generally, I think we’ve discovered,

that they will continue to flourish in some form or another. Robert Khuzami, chief of the SEC’s enforcement unit between 2009 and 2012, commented that he expects expert networks to continue to provide information because, in his view, the industry has been cleaned up.”<sup>22</sup>

Finally, the competitive need for an “edge” by hedge funds will drive traders’ conduct to the line of legality and sometimes beyond. The U.S. Attorney’s theory in the SAC cases included allegations that SAC’s culture of seeking an

***Yet, if a fund cannot beat the market and other asset classes, the modern hedge fund’s raison d’être disappears along with its lucrative fee structure.***

has been quite broad and quite deep. Fair to say that insider trading has been for a while, on Wall Street and elsewhere, rampant.”<sup>21</sup>

Second, it is clear that knowledgeable and empowered compliance officers and robust compliance policies are absolutely necessary to protect the adviser from liability in an environment where the quest for information about markets and companies is paramount to the company’s business. Like many hedge funds, SAC made use of expert network sources for information about industries in order to obtain color on potential investments. Some of those sources provided non-public material information about companies that SAC relied upon to trade securities. Although some commentators suggest that the use of expert networks will disappear, others contend

“edge” or advantage over other investors in the market was one of the causes of the criminal conduct.<sup>23</sup> Yet, if a fund cannot beat the market and other asset classes, the modern hedge fund’s raison d’être disappears along with its lucrative fee structure. As the *Economist* noted, “If having an ‘edge’ attracts unwelcomed attention, not having one is not much better.”<sup>24</sup>

### Dahl v Bain Capital Partners - Antitrust Conspiracy By Private Equity

In a long running and closely-watched case filed in 2007, a group of private equity firms were sued for allegedly colluding to drive down the price of corporate takeovers by agreeing not to compete or bid against each other in acquisitions of public companies. The lawsuit alleged violations of federal antitrust

law and was brought by a putative class of shareholders against 11 of the largest private equity firms.<sup>25</sup>

Plaintiffs contended that from 2003 to 2007, defendants rigged the market for 19 leveraged buyouts of publicly traded companies and eight related transactions. The result, according to plaintiffs, was that the target companies’ shareholders received lower prices for their stock than they would have had there been unrestrained competition. In an order dated, March 13, 2013, the court narrowed the scope of the plaintiffs’ theory of the case, while permitting plaintiffs to proceed against many of the defendants.

Plaintiffs initially alleged four types of competition limiting practices of the defendants. First, plaintiffs contend defendants formed bidding clubs or consortiums, through which they would band together to put forth a single bid for a target company. The plaintiffs assert that the purpose of these bidding clubs was to reduce the already limited number of private equity firms who could compete and to allow multiple firms to participate in one deal, thereby ensuring that every private equity defendant got a “piece of the action.” Second, plaintiffs assert that the defendants monitored and enforced their conspiracy through quid pro quos (or the exchange of deals) and, in the instances where rules were broken, threatening retaliatory action such as mounting competition against the offending conspirator’s deals. Third, to the extent the target company set up an auction, plaintiffs complain that defendants did their best to manipulate the outcome by

## PRIVATE FUND LITIGATION: FUNDS MAKE HEADLINES (cont.)

agreeing, for example, to give a piece of the target company to the losing bidders. Fourth, plaintiffs assert that the defendants refused to “jump” (or compete for) each other’s proprietary deals during the “go shop” period following the announcement of the deal. This allowed defendants to negotiate their acquisitions without the risk of competitive bidding.

The court rejected many of the plaintiffs’ theories and held that the evidence presented on summary judgment only supported an “over-arching agreement between the defendants to refrain from ‘jumping’ each other’s announced proprietary deals.”<sup>26</sup> Eight proprietary deals were identified.<sup>27</sup> The allegations of wrongdoing in connection with auctions were eliminated from the alleged conspiracy.

Dahl v. Bain Capital provides a rare window into the world of private equity firms and their strategies for acquisitions of public companies that will be of interest to private equity funds and their counsel as well as advisers of public targets.

### NML Capital, Ltd. v. Republic of Argentina - Private Funds v. Argentina

One of the most highly-publicized cases concerning private funds in 2013 involves hedge funds suing the government of Argentina over its bond restructuring. In 2001, Argentina defaulted on more than ninety-five billion dollars in debt. Over a period of about five years, Argentina restructured the defaulted bonds. The Argentine government offered new bonds to the holders of the defaulted bonds at



a rate of 25 cents to 29 cents on the dollar. This exchange restructured approximately 90% of the outstanding defaulted foreign debt. Several hedge funds, however, which had purchased the distressed sovereign debt on the secondary market refused to exchange the defaulted notes for the new restructured notes. These hedge funds sought enforcement of the defaulted Argentine bonds and commenced an action in the United States District Court for the Southern District of New York.

In October 2012, Judge Thomas Griesa issued orders enjoining Argentina from making payments on its restructured debt without making ratable payments to the hedge funds holding the defaulted bonds. The Second Circuit Court of Appeals affirmed that order.<sup>28</sup> The district court subsequently held that the bond documents required Argentina to treat its creditors under

the old defaulted bonds exactly like it treated its creditors under the new bonds. If it paid the creditors under the new bonds, then Argentina also had to pay the creditors holding the defaulted bonds. A petition for certiorari to the United States Supreme Court was filed by Argentina and is pending.<sup>29</sup>

The plaintiff hedge funds have sought to attach various Argentine assets in order to secure payment on the distressed bonds. Specifically, plaintiffs have attempted to attach taxes owed to Argentina, to attach diplomatic bank accounts in France and Belgium and to seize an Argentine Navy vessel in Ghana. In an attempt to put an end to this worldwide security grab, holders of the new restructured bonds have tried – so far unsuccessfully – to broker a settlement with the plaintiff funds.



## PRIVATE FUND LITIGATION: FUNDS MAKE HEADLINES (cont.)

Throughout the litigation, Argentina sought to portray the hedge fund plaintiffs as predatory for buying up the distressed debt. Argentina and its President, Christine Kirshner, referred to plaintiffs as vultures because they purchased distressed debt at deep discounts and then demanded payment in full, thereby destroying the chances for a restructuring of the country's debt. The Second Circuit was not impressed with the argument: "Argentina promised that

to avoid the situation in which Argentina finds itself in the U.S. courts.<sup>31</sup>

The outcome of the litigation over Argentina's bonds may be the precursor to future disputes in which hedge funds flex their financial and litigation muscles. Some hedge funds are turning their sights on sizable domestic distressed bonds. Hedge funds have been buying up subprime mortgage-based bonds that are

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each bond would be transferrable and payable to the transferee, regardless of whether it was a university endowment, a so-called "vulture fund," a widow or an orphan.<sup>30</sup>

The case provides an interesting insight into the business model of funds that purchase distressed sovereign debt and then have to use litigation to enforce the obligations. Further, the cases have received attention from other debtor nations who will be searching for ways

the subject of litigation against some of the larger Wall Street banks. Although those banks have settled suits brought by prominent investors including BlackRock and PIMCO, hedge funds are buying bonds that remain the subject of litigation. One fund, Fir Tree Partners, proposed to buy bonds that are subject to a possible settlement of a suit, signaling that it believed it could ultimately obtain a better return through continuing litigation than available under the settlement.

<sup>17</sup> Indeed, in response to market opportunities, some private funds are now investing in litigation. See e.g., "Why Are Hedge Funds Allowed to Invest in Litigation?" <http://www.theatlantic.com/national/archive/2012/07/why-are-hedge-funds-allowed-to-invest-in-litigation/259345/>

<sup>18</sup> <http://www.businessweek.com/stories/2003-07-20/the-most-powerful-trader-on-wall-street-youve-never-heard-of>

<sup>19</sup> SAC's fees were also high. It reportedly charged "3 and 50" (3% of funds under management and 50% of annual profits earned) as contrasted to the more common industry fees of "2 and 20." See e.g., "The Guy who is killing it at SAC Capital," <http://blogs.reuters.com/unstructuredfinance/2011/12/23/the-guy-who-is-killing-it-at-sac-capital>

<sup>20</sup> <http://www.justice.gov/usao/nys/pressreleases/November13/SACPleaDocs/SAC%20Indictment%20%28Stamped%29.pdf>; and <http://www.justice.gov/usao/nys/pressreleases/November13/SACPleaPR.php>

<sup>21</sup> See interview of the U.S. Attorney located at "Preet Bharara: Insider Trading Is 'Rampant' On Wall Street," <http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/to-catch-a-trader/preet-bharara-insider-trading-is-rampant-on-wall-street/>

<sup>22</sup> <http://www.thedeal.com/content/regulatory/enforcer-in-chief-a-conversation-with-robert-khuzami.php>

<sup>23</sup> The indictment of the SAC Capital Management Companies references "edge" at least 14 times.

<sup>24</sup> <http://www.economist.com/news/finance-and-economics/21582543-sac-capitals-legal-troubles-have-wider-ramifications-edge-fund>

<sup>25</sup> *Dahl v Bain Capital Partners LLC*, 07-12388, United States District Court, District of Massachusetts.

<sup>26</sup> Memorandum and Order, dated July 16, 2013

<sup>27</sup> A proprietary deal, as opposed to an auction, is a deal in which the Target Company will either deal with one buyer or a consortium of buyers and sign an agreement for sale. The signed agreement would then be announced to the public and the Target Company would have a period of time between the announcement of the signed agreement and its formal closing to find a better offer. During this "go-shop" period, the Target Company's financial advisor "proactively goes out to buyers, and also responds to all inquiries that are received, and tries to stimulate the interest and to create a higher bid for the company." Order, dated July 16, 2013, at p.5, n. 2.

<sup>28</sup> *NML Capital, Ltd. v. Republic of Argentina*, 699 F.3d 246 (2d Cir. 2012).

<sup>29</sup> The Supreme heard argument in April 2014 on a prior issue raised by Argentina in this case: Because the Foreign Sovereign Immunities Act of 1976 allows a court to seize property from a foreign government only if it is located in the U.S. and used for commercial activity, does a U.S. Court have authority to order disclosure of information about that nation's assets anywhere in the world.

<sup>30</sup> However, the Argentina's disparagement of the plaintiff funds garnered sympathy in some quarters "Stop 'vulture funds' from paralyzing debt-relief efforts," says UN independent expert," [http://www.un.org/apps/news/story.asp?NewsID=43768&Cr=foreign+debt&Cr1=#.UIRaP\\_vJZ8E](http://www.un.org/apps/news/story.asp?NewsID=43768&Cr=foreign+debt&Cr1=#.UIRaP_vJZ8E)

<sup>31</sup> See Anna Gelpern, "Sovereign Damage Control," Petersen Institute for International Economics, Number PB 13-12 (May 2013) found at <http://www.iie.com/publications/pb/pb13-12.pdf>

# COMMENTARY ON THE FIRST CIRCUIT'S DECISION IN *SUN CAPITAL*

The First Circuit's recent decision in *Sun Capital*<sup>32</sup> has garnered substantial attention in the tax community because it may overturn important assumptions in the taxation of private equity funds and some of their investors. This comment summarizes the decision and its tax implications, discusses what may happen next, reviews published commentary about the case, and connects the decision to debates about carried interest legislation.

## Summary of the *Sun Capital* Decision

In July 2013, the First Circuit Court of Appeals held that a subsidiary investment fund of private equity firm Sun Capital Advisors, Inc. was engaged in a "trade or business" for purposes of establishing pension fund withdrawal liability

engaging in a "trade or business." Without fully defining the "plus" factor, the First Circuit held that the fund was engaged in a "trade or business."

## Potential Implications

Because of statutory overlap, the interpretation of terms in ERISA is often considered persuasive, though not necessarily dispositive, guidance for the interpretation of similar terms in federal income tax law, and vice-versa. If the First Circuit's analysis regarding "trade or business" were applied in interpreting federal tax law, certain assumptions underlying the taxation of private equity investors may be overturned, leading to new sources of potential tax liabilities for the industry. For example, foreign investors in a private equity fund may be deemed to have

of the private equity fund being engaged in a "trade or business," they would not owe.<sup>35</sup>

Most notably, commentators have also suggested that the application of the First Circuit's analysis to a private equity income tax case could result in denial of the capital gains preferential rate for a fund manager's carried interest.<sup>36</sup> Typically, fund managers receive a management fee of 2% of the assets held by the fund and a carried interest, often referred to simply as "carry" in the industry, in the form of a 20% share of a fund's net profits allocated to the General Partner. The carry is only distributed when the fund is sufficiently profitable to clear a designated hurdle rate, commonly above 8%. Carried interest goes by this name because the profits are "carried over" from the limited partners to the general partner, who receives a share in the profits despite having no obligation to contribute capital to the fund.<sup>37</sup>

Fund managers have traditionally reported the carry as capital gains subject to preferential rates, currently set at 20%, rather than as ordinary income subject to the top rate of 39.6%. This relies on the fact that partnerships follow the pass-through principle – a partnership is not subject to tax, but the partners, in their individual capacities, pay tax on partnership income. For the individual partner, the character of the profits distributed to them is determined at the partnership level.<sup>38</sup> In other words, if the partnership receives income in the form of gain from the sale of a capital asset (as private equity

***The First Circuit adhered to an "investment plus" analysis: while passive investing is not considered engaging in a "trade or business," investing plus certain other facts, such as the investor's active management of the underlying company's business and the investor's receipt of benefits that passive investors generally would not receive, is considered engaging in a "trade or business."***

under ERISA.<sup>33</sup> The First Circuit adhered to an "investment plus" analysis: while passive investing is not considered engaging in a "trade or business," investing plus certain other facts, such as the investor's active management of the underlying company's business and the investor's receipt of benefits that passive investors generally would not receive, is considered

income effectively connected with a U.S. "trade or business," and may thereby be subjected to U.S. taxation on income that would otherwise not have been taxed by the United States.<sup>34</sup> Similarly, tax-exempt investors such as universities and charities that invest in a private equity fund may also be subject to taxes for unrelated business income, which, except for a finding

## COMMENTARY ON THE FIRST CIRCUIT'S DECISION IN *SUN CAPITAL* (cont.)

funds generally do because they buy and sell companies), then the individual partner reports and pays tax at the capital gain rate on allocations of income to them in their capacity as partners.

Criticism of the capital gain treatment of the carry centers on whether fund managers are actually receiving the carry as a return on their investment in their capacity as a partner or whether, like the 2% administrative fee, they are receiving the carry in their non-partner capacity as compensation for services. The latter characterization, which is similar to the treatment of nonqualified stock options, would subject the carry to ordinary income taxation.<sup>39</sup> Defenders of the current treatment for the carry respond that the proper analogy is not stock options, but rather the sweat equity an entrepreneur contributes in building their business from scratch. When they sell the business and realize the appreciation, the profits are considered capital gains rather than deferred compensation.

The potential impact of *Sun Capital* would be to provide a judicial avenue for critics of the capital gain classification of the carry. If the private equity fund was classified as a “trade or business” under *Sun Capital* and the fund manager was considered to be a developer who earned a profit by transforming, rather than merely investing in, the portfolio companies, then the profits from sales of the portfolio companies could be deemed to come from sales to customers in the ordinary course of “trade or business,” which is one of the exceptions to the capital asset definition.<sup>40</sup> That would mean the carry could be recharacterized as ordinary



income. Lest you conclude that the potential tax implications of *Sun Capital* are all bad, there are potential tax benefits to a private equity fund of an expansive interpretation of “trade or business.” Investment expenses may then be deductible as ordinary business expenses rather than as itemized deductions subject to limitations. Funds may also be able to claim an ordinary loss rather than a capital loss. The general view, however, is that an expansive interpretation of “trade or business” negatively impacts private equity funds, both in the tax context as well as the ERISA context, by increasing overall liability.

### The Future of *Sun Capital*

It is unclear whether the First Circuit intended that its holding, which strictly speaking is limited to the ERISA context, applies in interpreting tax law. The dicta language in *Sun Capital* suggests

that the First Court may not necessarily import its analysis of “trade or business” in the ERISA context into a tax context. The First Circuit observed that “[t]he phrase ‘trades or businesses’ [as used in the ERISA statute] is not defined in Treasury regulations and has not been given a definitive, uniform definition by the Supreme Court.”<sup>41</sup> The First Circuit noted that “[t]he Supreme Court has warned that when it interprets the phrase, it ‘do[es] not purport to construe the phrase where it appears in other places,’ except those sections where it has previously interpreted the term.”<sup>42</sup>

Nevertheless, the First Circuit’s “investment plus” analysis could influence a court deciding a similar case regarding a private equity fund in the tax context. It is not that the investment plus analysis is particularly novel, but rather that it is not often applied in the context of a private equity fund.<sup>43</sup> Courts including the

## COMMENTARY ON THE FIRST CIRCUIT'S DECISION IN *SUN CAPITAL* (cont.)



First Circuit may use the analysis in *Sun Capital* to interpret “trade or business” in the private equity tax context in a similarly expansive manner.

The First Circuit has declined to hear the case en banc.<sup>44</sup> The Supreme Court has also declined to hear the case.<sup>45</sup> Currently, there is no split among the Circuit Courts that would support intervention by the Supreme Court.<sup>46</sup> The case is currently on remand to the District Court of Massachusetts for determination of certain factual matters.

A Treasury Department official has suggested that the First Circuit’s decision in *Sun Capital* may allow the government the “opportunity to reassess what ‘trade or business’ means.”<sup>47</sup> Speaking at a bar association meeting in San Francisco in September, the Treasury official further noted that there would not be a “rush

to issue guidance” and that any action would be “policy driven.”<sup>48</sup>

### Published Commentary

The *Sun Capital* case has generated much commentary among tax practitioners. Many law firms have produced memoranda discussing the First Circuit’s decision and its possible implications for their clients and tax practitioner publications have published numerous articles opining on the *Sun Capital* case.<sup>49</sup> This section reviews a few of the prominent articles that have discussed the tax implications of the decision.

One of the earliest commentators following the *Sun Capital* decision is Steven M. Rosenthal, a visiting fellow at the Urban-Brookings Tax Policy Center. Rosenthal published an article in *Tax Notes* in September 2013, urging the Treasury

Department to write regulations confirming a broad application of *Sun Capital*, to the effect that private equity funds be treated as trades or businesses for various tax purposes.<sup>50</sup> Rosenthal argued, following an earlier article of his which was cited by the First Circuit in *Sun Capital*,<sup>51</sup> that private equity funds should be treated as being in the “trade or business” of being corporate developers, that is, buying companies at a low price, developing the company, and then selling them for a profit.<sup>52</sup> Rosenthal argued that the stock, in the hands of a private equity fund, of the corporations that the fund is developing, should not be considered capital assets, since the funds are more than just investors. Accordingly, the gains of a private equity fund upon disposition of the stock should not be taxed at capital gains rates but rather at ordinary income rates.

Other commentators have taken issue with Rosenthal’s analysis. Andrew Needham, a partner at the law firm of Cravath, Swaine & Moore, and the former chair of the New York State Bar Association Tax Section, argued that prior cases that narrowed the definition of “trade or business” can and should themselves be read broadly, with the result that Rosenthal’s analysis is incorrect as a matter of current law.<sup>53</sup> Monte Jackel, a former PriceWaterhouseCoopers LLP attorney and special counsel to the IRS, also took issue with Rosenthal’s analysis, questioning the relevance of the case for tax law and the incoherence of an argument that posits that the partnership should be treated as both an entity and an aggregate in the same transaction.<sup>54</sup> Some commentators have contended that the impact of *Sun Capital* is less dire for income



## COMMENTARY ON THE FIRST CIRCUIT'S DECISION IN *SUN CAPITAL* (cont.)

tax purposes than some have assumed, but the ERISA implications should not be overlooked. Lee Sheppard, a columnist for Tax Notes, opined that “*Sun Capital* does not put private equity investors in a ‘trade or business’ for tax

2014. Nevertheless, opposition to legislative reform of any kind in the tax arena, especially reform that increases taxes, remains firm. This suggests *Sun Capital* may be seized upon as a judicial and administrative alternative for

***The Senate Finance Committee recently issued a report that recommended taxing carried interest at ordinary rates, and President Obama’s budget for fiscal year 2014 proposes to tax carried interest at ordinary rates, as does the House Ways & Means tax reform proposal from February 2014. Nevertheless, opposition to legislative reform of any kind in the tax arena, especially reform that increases taxes, remains firm.***

purposes. It does put them in a ‘trade or business’ for purposes of withdrawal liability from terminated pension plans. That may be a bigger blow to private equity math than ordinary income treatment for investor returns would be.”<sup>55</sup>

### Conclusion

*Sun Capital* has become intertwined with the political debate over carried interest reform in part because carried interest tax legislation has not gotten far in Congress since being first proposed in 2007. There is some evidence of growing sentiment for reform, but it is far from certain that legislative action is likely anytime soon. News reports noted “a greater sense of acceptance, even among elected officials and some in industry who have voiced opposition in the past.”<sup>56</sup> The Senate Finance Committee recently issued a report that recommended taxing carried interest at ordinary rates,<sup>57</sup> and President Obama’s budget for fiscal year 2014 proposes to tax carried interest at ordinary rates, as does the House Ways & Means tax reform proposal from February

carried interest tax reform. One potential response from private equity would be to limit actions that might bolster the “trade or business” characterization. For example, the *Sun Capital* court cited monitoring fees, which funds charge to portfolio companies ostensibly to cover management and monitor services and are used to offset the administrative fee owed to the general partner, as one factor in the “trade or business” determination.<sup>58</sup> These fees are already under attack on a number of fronts,<sup>59</sup> including pushback from the limited partners, so they may be on the way out already. *Sun Capital* could accelerate this trend. The move to make structural adjustments that could help minimize the risk of “trade or business” classification may be one of the more immediate implications of the decision, which is sure to be on the minds of fund managers even if it not actually cited by the government in a tax proceeding against a private equity fund anytime soon.

<sup>52</sup> *Sun Capital Partners III LP et al. v. New England Teamsters and Trucking Industry Pension Fund*, 724 F.3d 129 (1st Cir. 2013). (“*Sun Capital*”).

<sup>53</sup> Employment Retirement Income Security Act of 1974, as amended (“ERISA”).

<sup>54</sup> See I.R.C. §§ 871(b) & 882.

<sup>55</sup> See I.R.C. §§ 511(a) & 512. This tax on proceeds from a “trade or business” that are substantially unrelated to the entity’s tax exemption is intended to reduce the competitive advantage over regularly-taxed business entities in the same industry.

<sup>56</sup> See Steven M. Davidoff, “A Chance to End a Billion-Dollar Tax Break for Private Equity,” N.Y. Times Dealbook (Oct. 23, 2013); Steven M. Rosenthal, “Private Equity Is a Business: *Sun Capital* and Beyond,” Tax Notes (Sept. 23, 2013).

<sup>57</sup> Under state partnership law, distributions may either follow capital contributions or may be distributed on any other basis agreed by the partners.

<sup>58</sup> I.R.C. § 702(b).

<sup>59</sup> See I.R.C. § 707(a) (authorizing the recharacterization of an allocation and distribution as compensation income to a non-partner if the allocation and distribution of profits are considered payment for the partner’s performance of services for the partnership).

<sup>60</sup> I.R.C. § 1221(a)(1).

<sup>61</sup> *Sun Capital* at 12. The First Circuit cited Commissioner v. Groetzinger, 480 U.S. 23, 27 (1987), and observed that “despite the widespread use of the phrase in the Internal Revenue Code,” the Supreme Court in Groetzinger noted that “the Code has never contained a definition of the words ‘trade or business’ for general application, and no regulation has been issued expounding its meaning for all purposes.” *Sun Capital* at 12.

<sup>62</sup> *Id.*

<sup>63</sup> There is, however, at least one recent tax case addressing the trade or business question in the private equity context. See Dages v. Commissioner, 136 T.C. 263 (2011) (finding that the general partner, but not the fund itself, was a “trade or business”).

<sup>64</sup> United States Court of Appeals for the First Circuit, Denial of Petition for Rehearing in *Sun Capital III, LP et al. v. New England Teamsters & Trucking Industry Pension Fund* (Aug. 23, 2013).

<sup>65</sup> *Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, U.S., No. 13-648, cert. denied Mar. 3, 2014.

<sup>66</sup> United States Court of Appeals for the First Circuit, Denial of Petition for Rehearing in *Sun Capital*, supra note 44.

<sup>67</sup> Amy S. Elliott, “*Sun Capital* May Provide Opportunity to Reassess ‘Trade or Business,’ Treasury Says,” Tax Notes (Sept. 30, 2013).

<sup>68</sup> *Id.* (comments of attorney-adviser Craig Gerson of the Treasury’s Office of Tax Legislative Counsel).

<sup>69</sup> See, e.g., Ivan Mitev, “*Sun Capital*: ‘Trade or Business’ Armageddon Talk,” Private Equity, Venture Capital and Hedge Fund Taxation, <http://fund-taxation.com> (Aug. 9, 2013); David S. Denious et al., “*Sun Capital Partners*: Some Alternative Perspectives,” Drinker Biddle (Sept. 13, 2013).

<sup>70</sup> Rosenthal, supra note 36.

<sup>71</sup> Steven M. Rosenthal, “Taxing Private Equity Funds as Corporate ‘Developers,’” Tax Notes (Jan. 21, 2013). See also *Sun Capital* at 5 (citing Rosenthal’s January 2013 article in support of the First Circuit’s analysis).

<sup>72</sup> Rosenthal, supra note 20.

<sup>73</sup> Steven M. Rosenthal & Andrew W. Needham, “Taxing PE Funds and Their Partners: A Debate on Current Law,” Tax Notes (June 10, 2013).

<sup>74</sup> Monte A. Jackel, “*Sun Capital*: The Demise of Private Equity?” Tax Notes (Aug. 26, 2013).

<sup>75</sup> Lee A. Sheppard, “The *Sun Capital* Decision in Perspective,” Tax Notes (Sept. 23, 2013).

<sup>76</sup> Aaron E. Lorenzo, “Hill Staff Sees Changing Attitudes on Taxing Carried Interest; Could Be Part of Tax Reform,” Bloomberg BNA Daily Tax Report (May 10, 2013). See also Steven M. Davidoff, “A Chance to End a Billion-Dollar Tax Break for Private Equity,” N.Y. Times Dealbook (Oct. 22, 2013) (stating that the co-founder of private equity firm Blackstone, Peter G. Peterson, has acknowledged that he “can’t justify” taxing carried interest at capital gains rates instead of ordinary rates) (citing Peter Lattman, “Peterson’s Public Break from Private Equity’s Line on Taxes,” N.Y. Times Dealbook (Nov. 29, 2010)).

<sup>77</sup> Senate Finance Committee Staff, Types of Income and Business Entities, Tax Reform Options for Discussion (June 6, 2013).

<sup>78</sup> *Sun Capital*, 724 F.3d at 143.

<sup>79</sup> See Dan Primack, “The Death of Private Equity’s Fee Hogs,” Fortune (Sept. 5, 2013); Gregg D. Polsky, “The Untold Story of *Sun Capital*: Disguised Dividends,” Tax Notes (Feb. 3, 2014) (arguing that monitoring fees, a common feature of private equity deals, should be considered a disguised dividend and their deductibility disallowed under current tax law).



# CONCLUSION: LOOKING TO 2015

Despite murmurs during the global financial crisis, reports of the demise of private equity and hedge funds proved to be premature. In 2014, it is clear that these funds are robust participants in our economic lives. The focus of those concerned with issues of legal liability, operational compliance, and regulatory policy is increasingly on determining the most effective way to oversee private funds, given the other priorities that the SEC, the CFTC, and relevant government departments must concurrently pursue.

This Report is a first step towards asking better questions about the strengths and weaknesses of the current regulatory regime applicable to

it is important to include the perspectives, experiences, and insights of California-based funds managers, investors, and other interested parties in the wider discussion. Our inaugural conference, “A View From California,” initiates a conversation about the current challenges and opportunities that California-based private equity and hedge funds are facing.

Going forward, the Report will seek the views of the private fund community in California regarding the pressing issues and concerns that should be addressed by taking full advantage of these local resources, while at the same time keeping a watchful eye on national and international developments.

- To what extent do California-based fund managers’ experiences with the federal regulatory regime differ from those of managers across the country?
- How will the globalization of private funds, particularly in the emerging regions of Latin America, Southeast Asia, and Sub-Saharan Africa, provide important opportunities to Californian managers and investors?
- In light of the importance of public pension plans to private equity and hedge funds, to what extent should the individuals managing the invested capital within private funds more closely resemble the diversity of the ultimate beneficiaries?
- Will the increased use of separately managed accounts, rather than commingled fund vehicles, materially change the relationship between managers and investors?

We look forward to your input and feedback on these issues, as well as any others that you feel will materially impact private funds in the future.

***Given the historic role of UCLA School of Law as one of the leading educational institutions in California, and the mandate of the Lowell Milken Institute for Business Law and Policy to bridge the divide between the academy and legal practice using creative partnerships and vibrant debate to shape the future of business law and policy, we believe it is important to include the perspectives, experiences, and insights of California-based funds managers, investors, and other interested parties in the wider discussion.***

private funds. Given the historic role of UCLA School of Law as one of the leading educational institutions in California, and the mandate of the Lowell Milken Institute for Business Law and Policy to bridge the divide between the academy and legal practice using creative partnerships and vibrant debate to shape the future of business law and policy, we believe

Looking to 2015 and beyond, there are areas of legal and regulatory concern that will remain a priority, including:

- How do the recent reforms help investors better exercise their contractual and other rights associated with their investments in private funds?