

Private Equity Fund Formation: Choice of Entity, Fundraising Trends, SEC Regulatory Issues, Tax Concerns

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Private Equity Fund Formation: Choice of Entity and Jurisdiction, SEC Regulatory Issues, Tax Concerns



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Speakers



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During this Webinar, We will Discuss:

- I. Formation Structures

- II. Selected Tax Issues

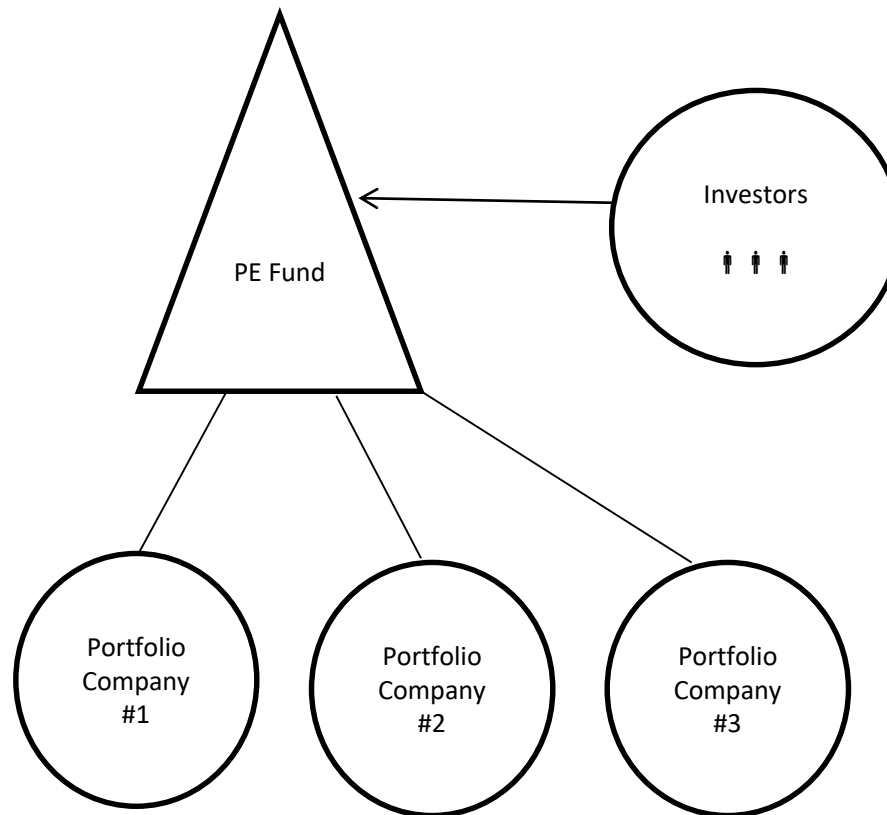
- III. Regulatory Issues Relevant to
Private Equity Funds

I. Formation Structures

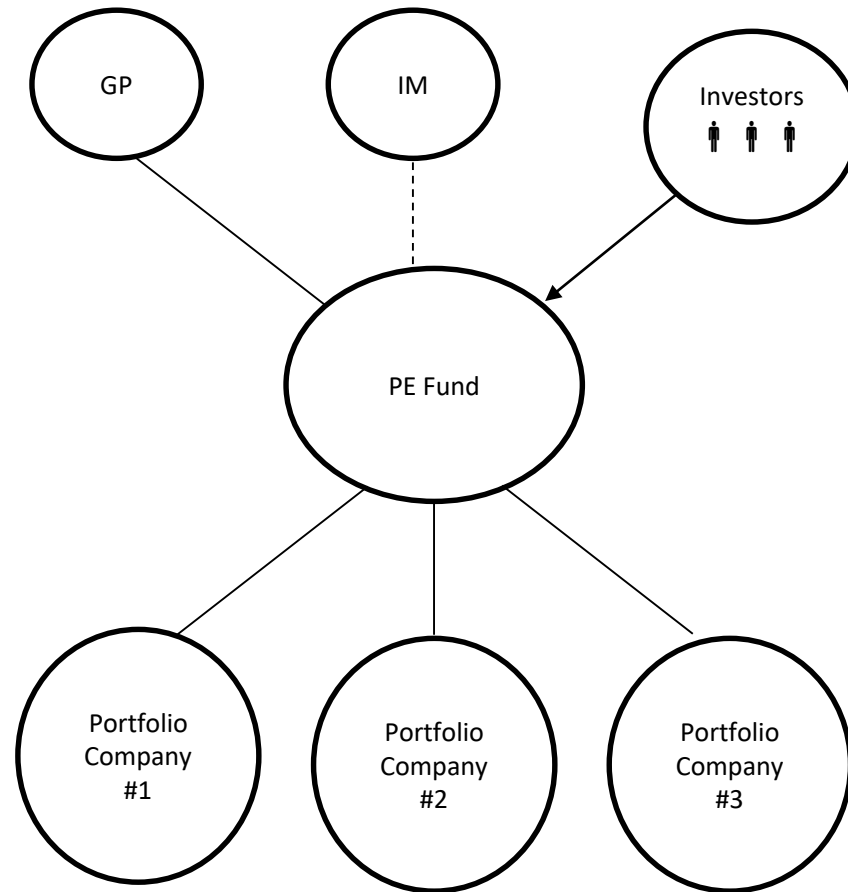
New Developments

- LP Regime being adopted in Ireland
 - Already in Luxembourg
- BEPS in Europe, etc.
- Substance Requirements in Offshore and in Europe

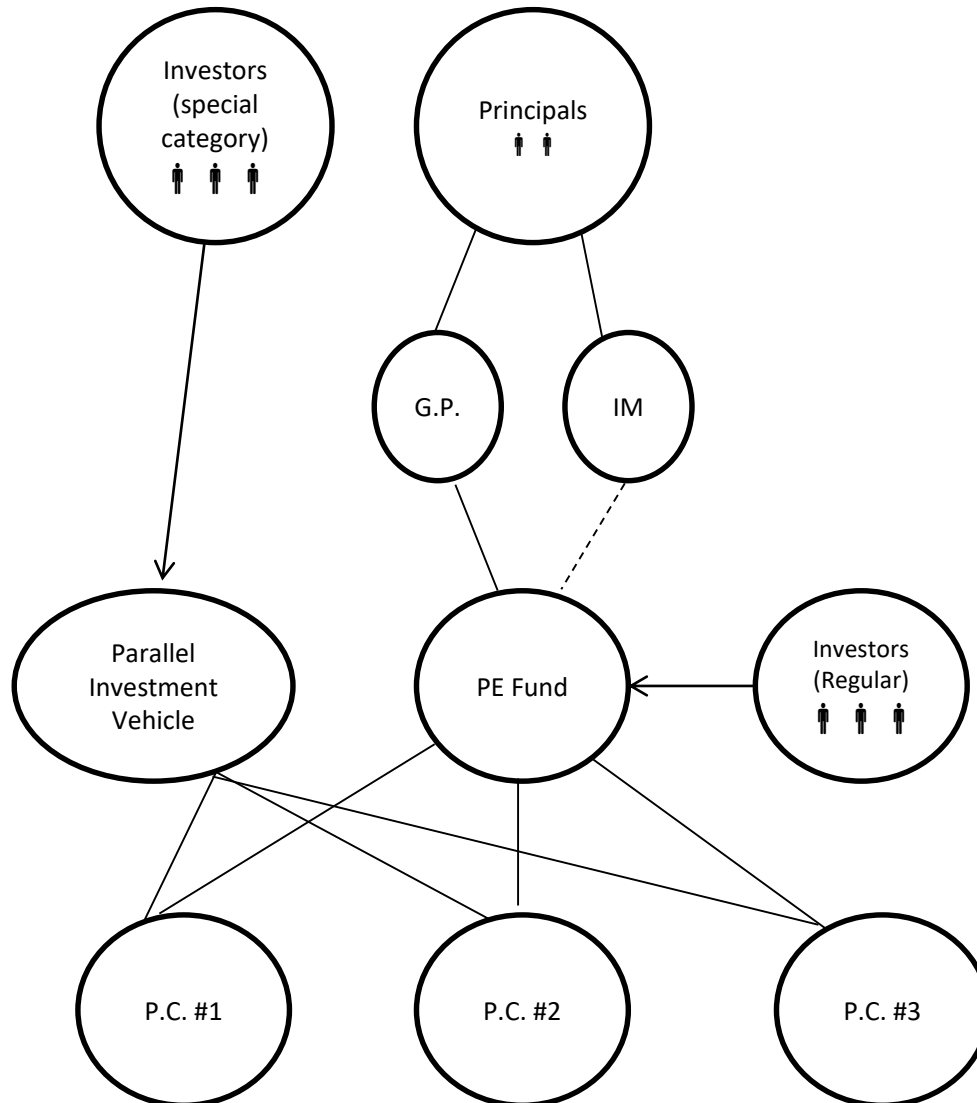
Basic P.E. Structure



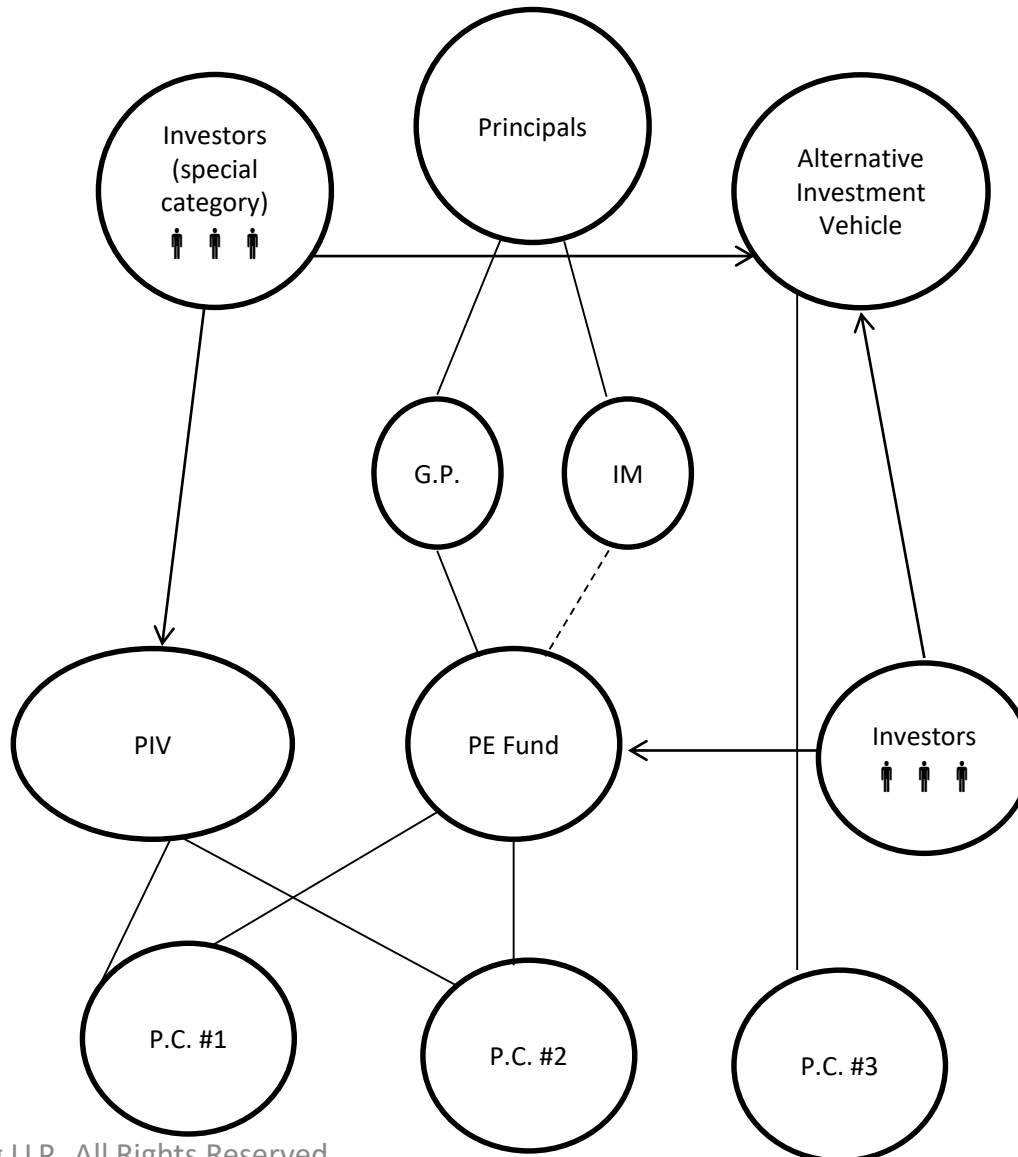
Basic Structure with Management Entities



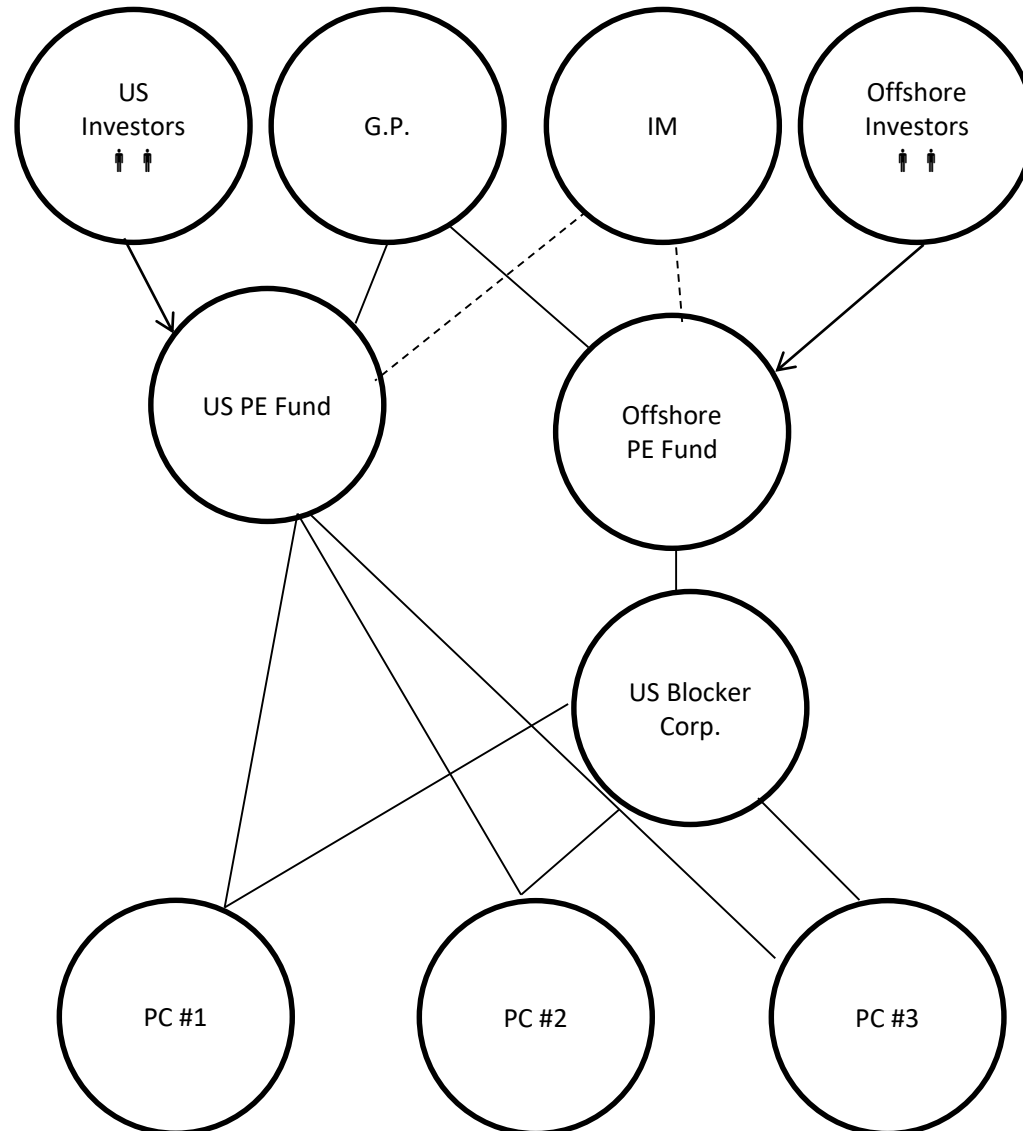
Parallel Investment Vehicle Structure



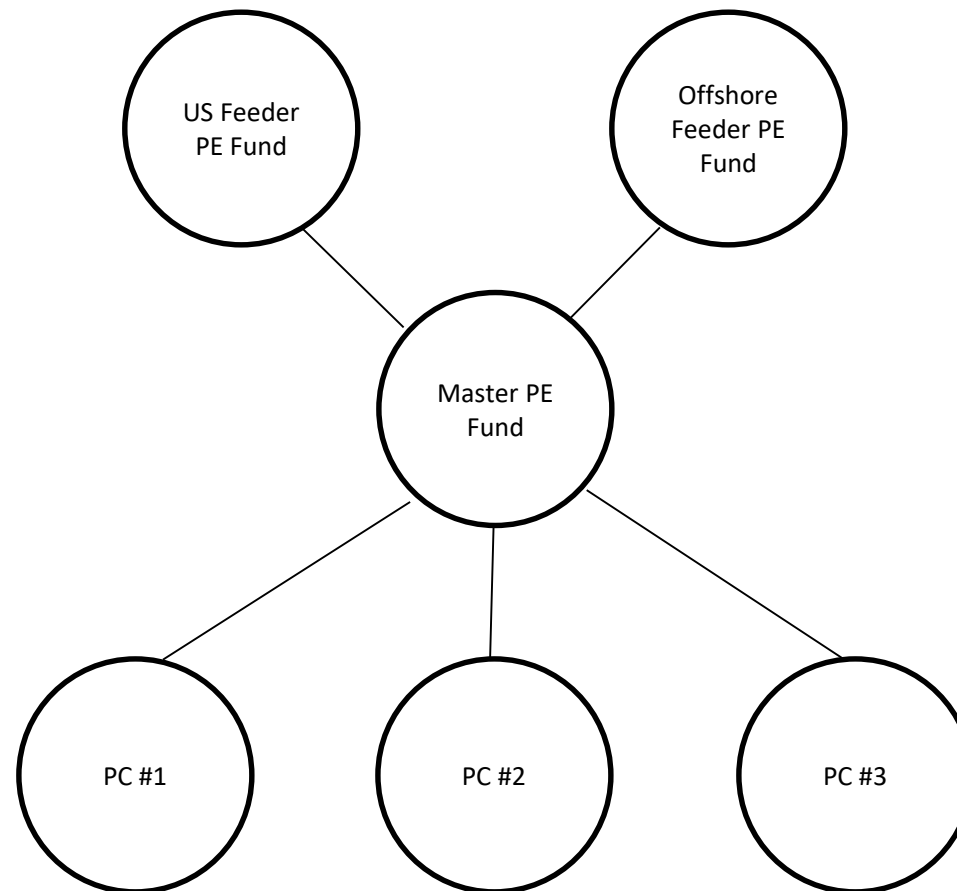
Alternative Investment Structure



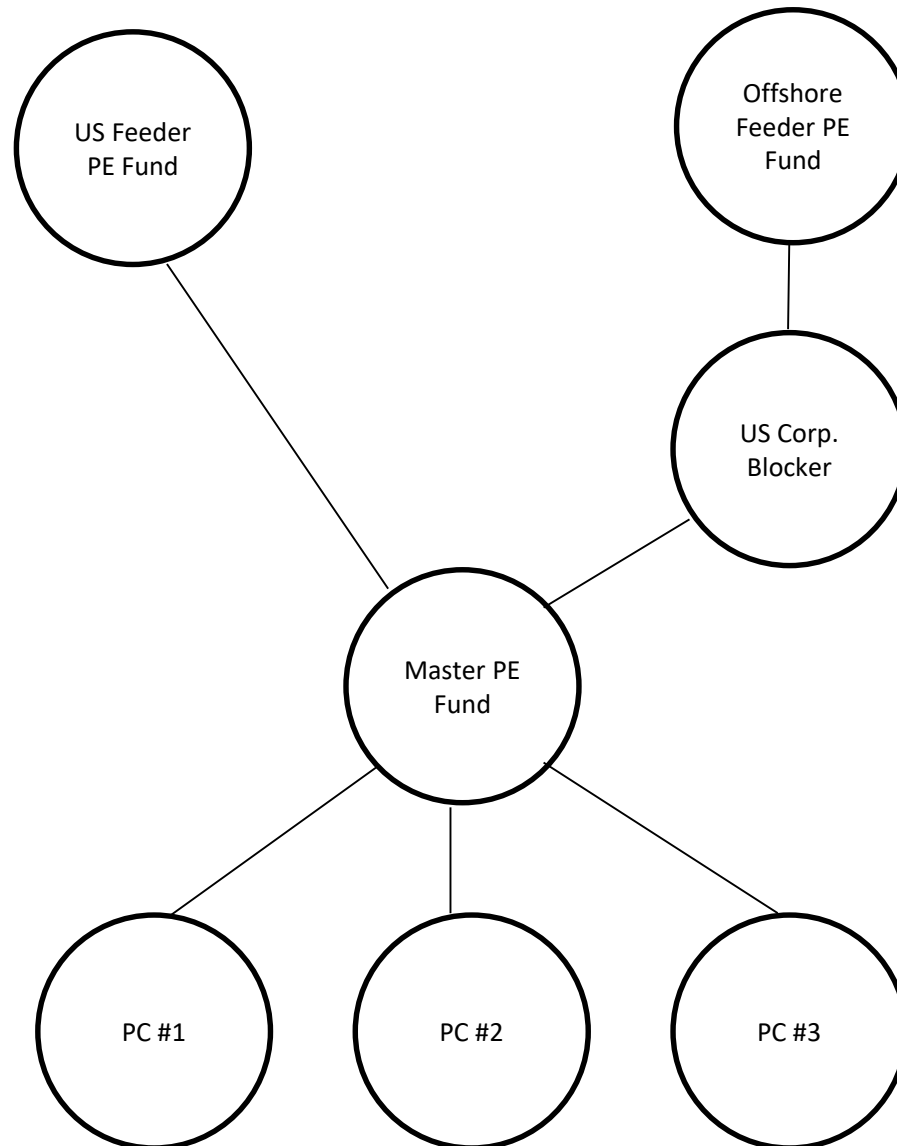
Blocker Structure



Master Feeder Structure



Master Feeder Blocker Structure



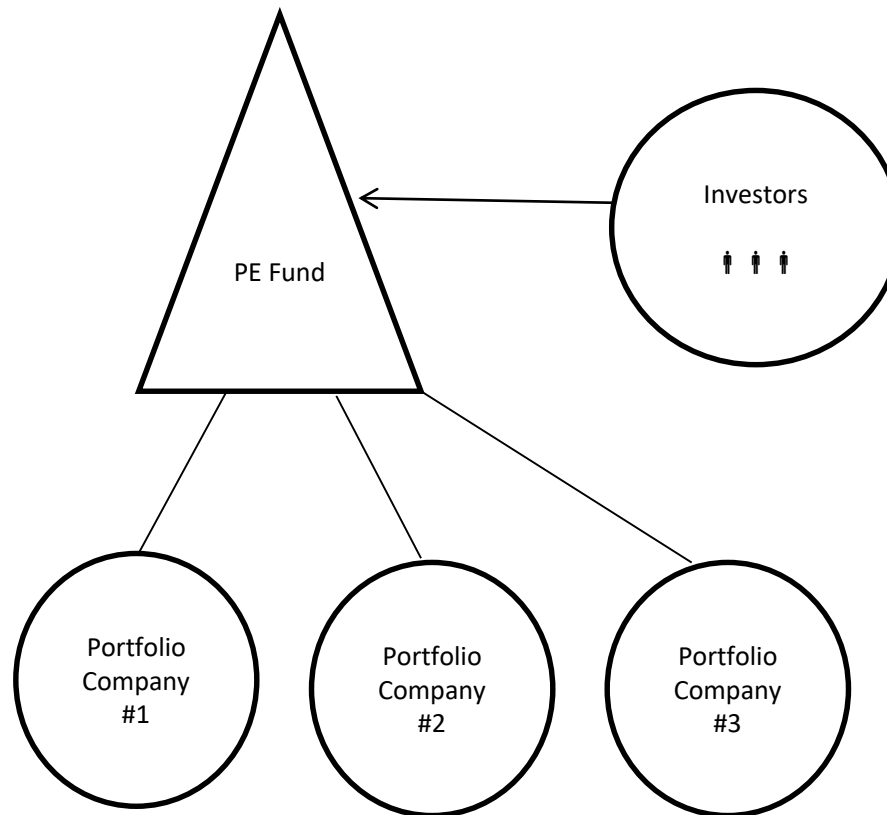
General Tax Considerations

- PE Funds as partnerships
- Pass-through of income to investors and GP
- Character passes through as well
- Tax planning for different types of investors and GP, with sometimes competing tax goals

Formation Checklist

- Is entity needed?
- What jurisdiction?
- What type of entity?
- Where does it fit in the larger structure of corporate organization chart of fund and management entities?

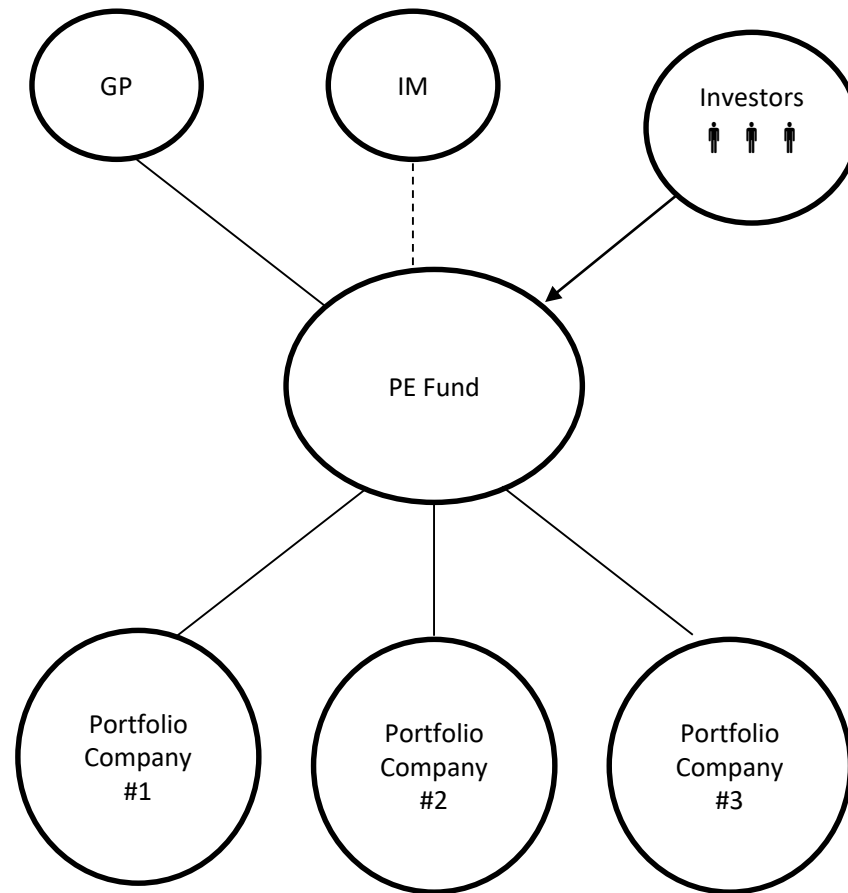
Basic P.E. Structure



Fund Entity

- Transparent – could be LP, LLC
- LP or LLC are typical alternating
- LP is most typical choice
- LLC used by West Coast firms and those primarily in VC world
- LLC superior in that there is not GP with unlimited liability
- LP superior in that state law, and especially Delaware law, give presumption of control and discretion to GP – for LLCs, not necessarily the case

Basic Structure with Management Entities



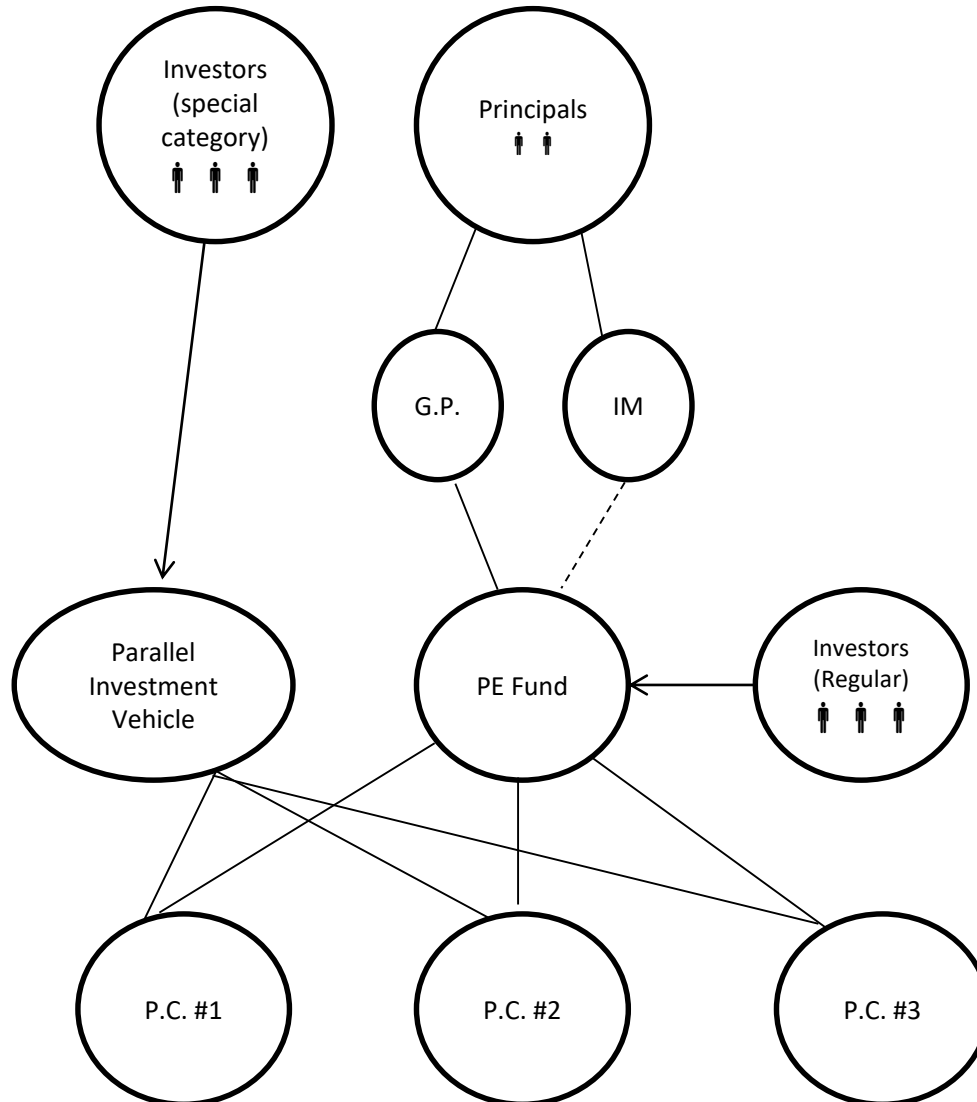
Management Company Structure

- Transparent typically
- LLC is typical choice because principals want a level playing field
- LP sometimes chosen for certain reasons – e.g. self-employment tax
- Practice Tip: If any principals from Canada, U.S. LLCs may not work because Canada views them as not transparent for tax purposes and tax treaty issues may arise
- Newer Developments:
 - Substance Requirements
 - Cayman vehicles being shut down and moved

Portfolio Companies

- Usually a corporation
- Sometimes Transparent
- LLC is typical choice, if Transparent
- Canada etc. – beware of investors from countries where laws do not parallel those of the U.S. with respect to LLCs.

Parallel Investment Vehicle Structure



Parallel Investment Vehicles

- Tax or Regulatory reason for requiring a separate fund in a parallel (i.e. side-by-side) structure to PE fund
- Offshore – the entity is typically offshore to address the tax issues raised
- Transparent – Generally, but not always
- Company vs. LP/LLC – since entity is offshore, the relevant jurisdiction may have no or little income tax – allowing a real choice between a Company electing to be treated as transparent for US tax purposes

Parallel Investment Vehicles: Other Considerations

- Cayman & other jurisdictions: entities with capital calls cannot be corps because shares are then not fully paid
- Anomaly: PE vs. Hedge in Cayman and similar jurisdictions
 - Hedge Funds historically structured as Corporations because of directors
 - PE not possible – local counsel recommend LPs
 - Cayman and others adopted LP law based on Delaware
 - Delaware use further reinforced by foreign adoption of similar statutes
 - LLCs not available until recently in Cayman and similar jurisdictions

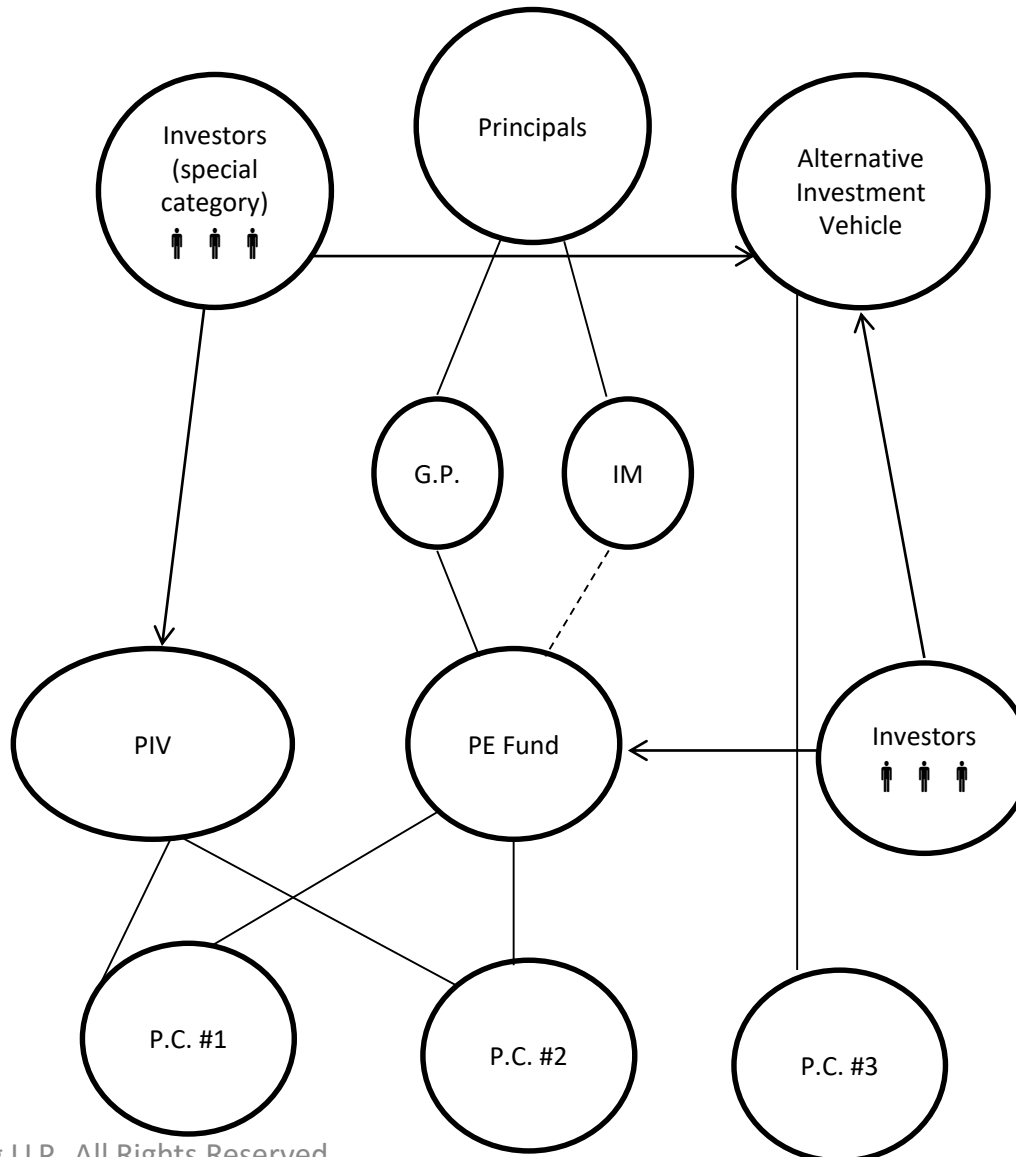
Parallel Investment Vehicles: Other Considerations

- However – Ireland, Lux (until recently), Malta, etc. did/do not have LP statutes that worked well for PE – local counsel did not recommend
- Historically, clumsy structures in these jurisdictions for PE funds
 - example: capital calls often do not appear in the governing documents –
 - awkward results – e.g. such provisions only in sub docs

Parallel Investment Vehicles: Significant Developments

- Luxembourg adopted LP statute –
 - widely in use by UK firms
- Ireland – proposed legislation not yet passed
 - Historic Antipathy to LPs – no directors – but obviously changing
- BEPS

Alternative Investment Structure



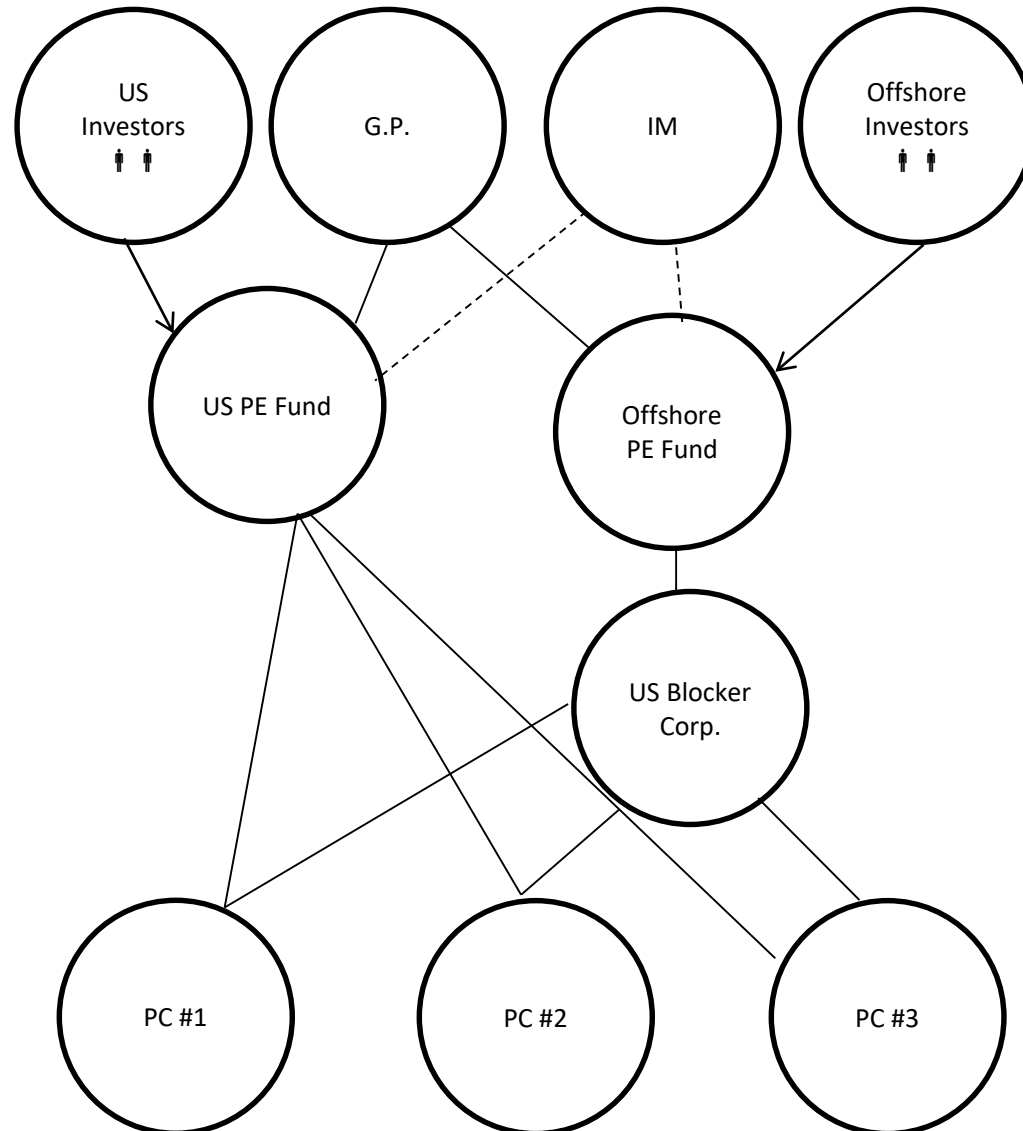
Alternative Investment Vehicles

- Specific P.C. Raises Tax or Other Issues – not special investor class
- Special “Parallel” Vehicle Created
 - Cannot call it “PIV” because name is already used
 - Investors in PE fund also invest in AIV to obtain access to P.C. without going through overall structure

Alternative Investment Vehicles

- AIV Characteristics?
 - Transparent vs. opaque
 - Onshore vs. offshore
 - Form of entity
 - Unknown – difficult to generalize due to broad use of vehicle, depends on what motivates use of entity

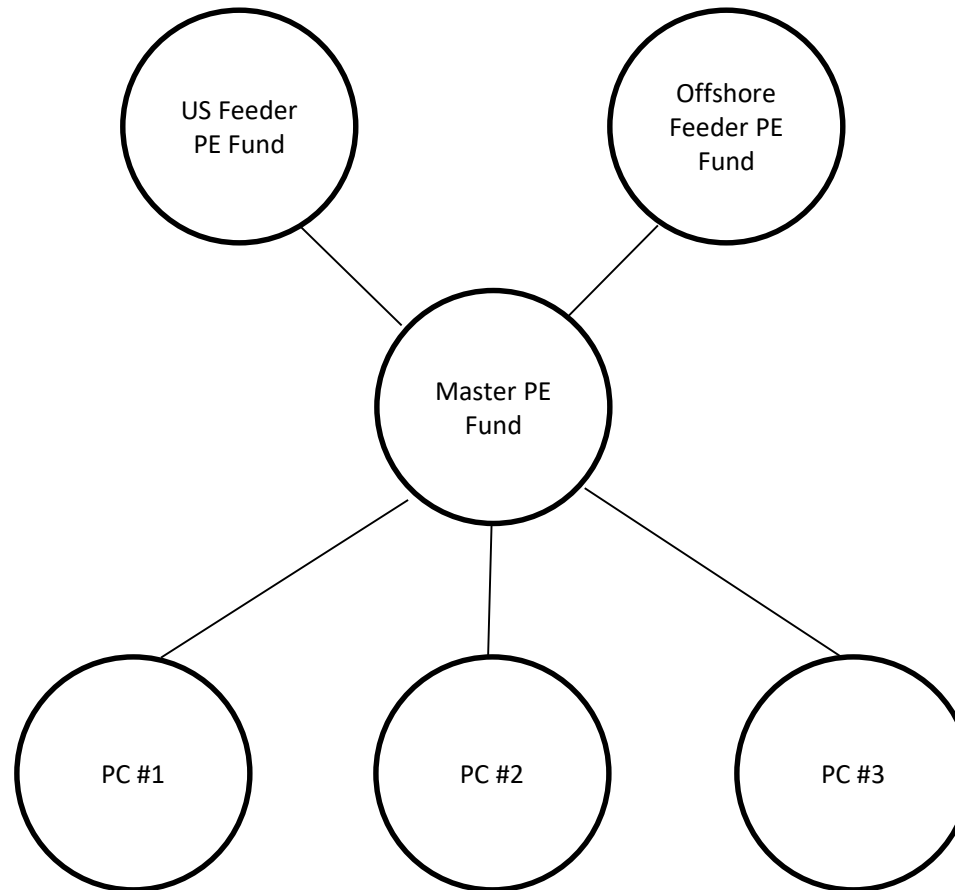
Blocker Structure



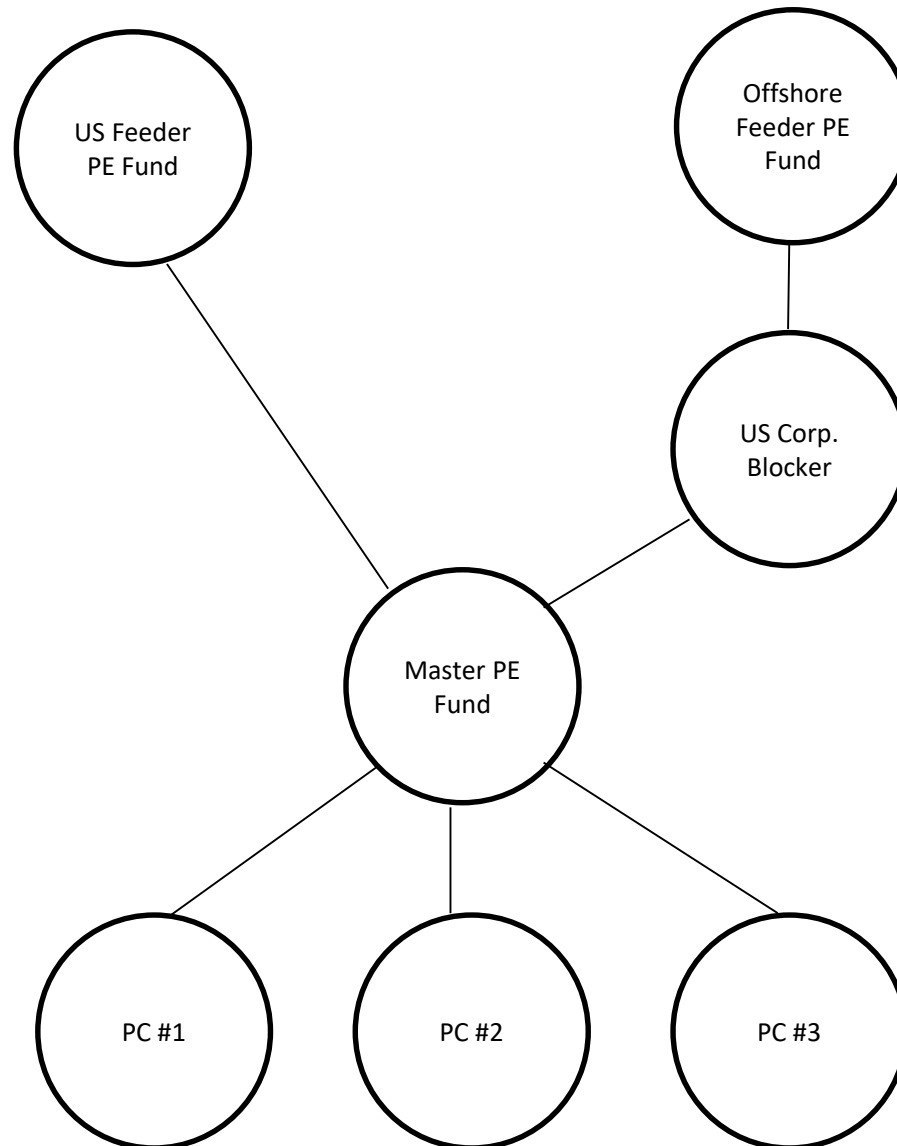
Blocker Structures

- Tax – typical motivation
 - UBTI
 - ECI
 - FIRPTA
- Fund can be Transparent – often because US blocker achieves the “opaque” requirements for structure
 - e.g. blocking UBTI, ECI, FIRPTA
- Nevertheless – Fund can be sometimes opaque because of secondary goals
 - e.g. Portfolio Interest, IRS filings/secretcy
- PIV/AIV use of blockers
 - Not just for offshore funds

Master Feeder Structure



Master Feeder Blocker Structure



Master Funds

- Rebalancing issue
 - Taxable event avoidance

- Jurisdiction
 - If US assets, typically US master
 - If both US and Offshore assets – “double blocker” structure
 - If offshore assets – typically desire offshore master
 - Anomaly- hedge fund masters often offshore U.S. P.E.
 - Master Feeder and Blocker structures often go together

Master Funds

- Legal entity
 - If US
 - typically LP/LLC, etc., for US taxable investors because it needs to be transparent
 - If Offshore
 - Since Can be LP/LLC, etc. in any structure
 - Can be Company since it can elect to be US partnership
 - no local taxes (or low taxes)
 - If not treated as a partnership for US tax purposes, then PFIC/CFC must be addressed

II. Selected Tax Issues

General Partner and Its Owners

- GP entity also a partnership for tax purposes
- Carried interest – a profits interest in the partnership
- Most income of most PE funds is LTCG
- Section 1061 enacted as part of 2017 Tax Reform Act
 - 3 year threshold
 - Grants of profit interests to members/partners of GP

Management Company and Its Owners

- Management company is also a partnership for tax purposes
- Management fee waivers
- Proposed regulations would curb this practice

U.S. Tax Exempt Investors

- Special sub category: “super tax exempts” – state partnership plans
- Except for this special category, U.S. tax exempt investors are subject to tax on their “UBTI” (unrelated business taxable income)
- Many tax exempt investors request or demand that the GP covenant not to create UBTI (or more than a small amount of UBTI) for them.

U.S. Tax Exempt Investors

- Exclusions for UBTI: interest, dividends, capital gains, etc. but not if from “debt-financed property”
- Investments in partnerships that operate businesses can create UBTI
- Debt at the fund (not corporate portfolio company) level
- Self-funding
- Fee income from portfolio companies
- Blockers for UBTI

Non-U.S. Investors

- Special category: foreign sovereigns subject to their own special rules
- Other non-U.S. investors: generally have a strong preference not to be deemed to be engaged in a U.S. “trade or business” – tax return requirements potentially a high tax rate, entry into U.S. “tax system”
- Subject to withholding tax on certain U.S. source income without a U.S. business
- Investing in securities, without more, is not a trade or business
- Trade or business status passes through a partnership (or multiple levels of partnerships)

“Blocker” Corporations for U.S. tax-exempt and non-U.S. Investors

- Unlike a partnership, the income of a corporation is its own. Thus, business activities of the corporation do not pass through to tax-exempt and foreign investors.

III. Regulatory Issues Relevant to Private Equity Funds

Conflicts, Transaction Fees; Other Regulatory Issues

- SEC and Institutional focus on these conflicts
- Emphasis on giving the limited partnership advisory committee (“LPAC”) approval rights over affiliate transactions and requiring GPs to disclose all transaction fees and services provided by affiliates
- Pressure from LPs to eliminate GP share of transaction/monitoring fees
- SEC concerns include transparency (full, fair and timely disclosure to investors)
- Arms length

Frequently Overlooked Regulatory Considerations

- Broker-Dealer Regulation
- Investment Adviser Regulation

Broker Dealer Regulatory Considerations

- Basic Rule: Transaction based compensation in securities deal requires broker-dealer registration
- Compensation could be obvious, as in commissions, or “disguised” (e.g., management and incentive fees where no IA services provided)
- Compliance professionals insist on greater compliance with registration
- SEC itself now very focused on these violations and prosecutes them
- Issue: Club Deals may be sponsored by third parties, who are neither existing registered broker dealers (or broker dealer reps) or investment advisers
- Such parties expect to be compensated

Investment Adviser Considerations

- Many sponsors, when made aware of the broker dealer regulatory considerations, and the difficulty of meeting requirements, often turn quickly to alternatives
- Most frequent alternative: sponsor acting as investment adviser and collecting management and/or incentive fees
- However, the SEC would regard a sponsor who does not provide any investment advice as a disguised broker dealer, and the fees as disguised commissions

Investment Company Act

- Need for exemption under ICA
- Often overlooked because vehicle is not a “blind pool”(conventionally thought of as a fund)
- Classic Exemptions of 3(c)(1), 3(c)(5), 3(c)(7) would be most relevant
- Increased possibility of availability of 3(c)(5)
- Such increased availability may even serve as a rationale for using the whole SPA/structure

SEC's Pronouncements on Conflicts

- Fees charged by fund managers directly to portfolio companies
- Allocations of investment opportunities
- Allocations of expenses among funds and co-investment vehicles
- Concerns raised about rates on legal fees charged to PE funds and their portfolio companies vs. those of the principals

SEC's Enforcement Cases

- *In the Matter of Fifth Street Management LLC, Admin. Proceeding File No. 3-18909* (December 3, 2018): Fund manager misallocated expenses (such as rent, overhead, and compensation) to its business development company clients as well as failed to review valuation models that caused a client to overvalue its portfolio companies.
- *In re Blackstreet Capital Mgmt. et ano.*, (June 1, 2016): Charged (i) broker fees for purchasing portfolio cos., without SEC registration; (ii) \$450k in oversight fees to 2 portfolio cos., (iii) for political/charitable contributions & entertainment expenses & (iv) acquired shares in portfolio cos. & LP interests in PE Fund from others, when should have been repurchased by cos. or reverted to Fund & investors. \$3.1MM sanctions.

SEC's Enforcement Cases

- *In re Cranshire Capital Advisors, LLC* (Nov. 23, 2015): Improperly charged fund Manager's own expenses for attorney for compliance consulting (i.e., registration and compliance program), and for office supplies, computers and utilities.
- *In re Cherokee Investment P'rs, LLC*, (Nov. 5, 2015): Manager charged Fund for compliance consultant expenses relating to registration and compliance consulting and legal expenses arising from SEC Exam and Investigation
- *In re Clean Energy Capital et ano.* (Oct. 17, 2014): Improperly charged Manager's overhead (i.e., salaries, bonuses, benefits & rent) to Funds and caused Funds to borrow from Manager at a high interest rate of 17% while pledging Fund assets as collateral. Changed calculation of dividend distributions adversely to some investors. \$2.2MM sanctions

SEC's Enforcement Cases

- *In re Blackstone Mgmt. P'rs.* (Oct. 7, 2015): \$39MM in sanctions for PE manager accelerating monitoring fees to portfolio cos. at time of IPO/private sale & getting legal discounts based on Fund using law firm.
 - Blackstone Management charged portfolio companies owned by Funds annual monitoring fees, and accelerated the annual monitoring fees upon the IPO or Private Sale of company.
 - Only Disclosed “ability to collect monitoring fees prior to... commitment of capital but did not disclose its practice of accelerating monitoring fees until after it took the fees.”
 - Conflict of Interest in decision to accelerate: benefits Manager at expense of investor profit.

SEC's Enforcement Cases

- *In re Apollo Mgmt. V, L.P., et al.*, (Aug. 23, 2016): \$52.7MM in sanctions for misleading disclosures about accelerating portfolio monitoring fees and loan from Fund to Apollo Mgmt. affiliate
 - As in Blackstone, Apollo accelerated annual monitoring fees upon IPO/Private Sale of Portfolio Co.
 - Apollo only disclosed ability to charge monitoring fees in offering documents, but only disclosed acceleration of monitoring fees after investors committed capital and Apollo accelerated.

SEC's Enforcement Cases

- *In re JH Partners, LLC*, (Nov. 23, 2015): PE Manager caused multiple Funds to invest in same portfolio cos. at different seniority (loans), priority (liquidation) & valuations, potentially favoring one client over other.
 - Manager also loaned over \$60 million to portfolio companies without disclosing to investors or LP Advisory Committee; created conflict in seniority with investors and due to using portfolio company assets as collateral.
 - Manager waived \$24MM in management fees & carried interest; agreed to subordinate \$60MM loan to Fund's investment interest in portfolio cos.; and \$225k in civil penalties. LPAC disclosure after fact not enough.

SEC's Enforcement Cases

- *In re Kohlberg Kravis & Roberts & Co.* (June 29, 2015): First broken deal expenses action.
 - \$30MM in sanctions for not clearly disclosing charging \$338MM in broken-deal & due diligence expenses to investors only – but not to PE co-investors who also benefitted from expenses.
 - Key Factor in Sanctions: Co-Investors included many KKR executives and officers, making conflict greater.

Investment Adviser Registration: Who is Required to Register?

- Investment advisers that manage between \$100 million and \$150 million in assets that manage one (1) or more managed accounts must register with the SEC.
- Investment advisers that manage less than \$100 million in assets generally must defer to the relevant investment adviser statutes in the state(s) where they conduct business.
- Investment advisers that can rely on the Private Fund Adviser Exemption may still need to become an Exempt Reporting Adviser with the SEC.

Investment Adviser Registration: Who is Required to Register?

- Investment advisers must include all gross assets (including leveraged amounts) in calculating assets under management.
- Investment advisers to private equity funds must include uncalled capital commitments (not just drawn down capital) in calculating assets under management.

CFTC Rules Impact on Private Investment Funds

Will You Need to Register as a Commodity Pool Operator?

- **Background:**

- Any fund trading even a penny of “commodity interests” is considered a “commodity pool,” and its operator must register as a CPO with the CFTC, unless an exemption is available.
- “commodity interests” include futures contracts (including security futures), commodity options and retail off-exchange forex transactions.
- Most commonly used exemption for operators of private funds has been the 4.13(a)(3) exemption.

CFTC Rules Impact on Private Investment Funds

- **4.13(a)(3) Exemption**

- typically used by operators of 3(c)(1) funds
- permits a de minimis amount of trading of commodity interests
- either (i) the aggregate initial margin and premiums required to establish commodity interest positions, determined at the time the most recent position was established, will not exceed 5 percent of the liquidation value of the fund's portfolio (taking into account unrealized profits and losses) (the "Margin Test") or (ii) the aggregate net notional value of the fund's commodity interest positions does not exceed 100 percent of the portfolio's liquidation value (the "Net Notional Test")
- the fund may generally not be marketed to the public as a vehicle for trading in commodity interests
- Note: The JOBS Act allows general solicitations in connection with Rule 506(c) offerings sold only to accredited investors.

CFTC Rules Impact on Private Investment Funds

- **4.13(a)(3) Exemption Modified**

- Claiming this exemption had required a “one-time” filing, but now the filing must be made annually within 60 days after every calendar year end.
- “Swaps” will be included as “commodity interests” 60 days after the final rules defining “swap” have become effective.
- “Swaps” are expected to exclude swaps on single securities or a narrow index of securities, but are expected to include swaps on a broad-based security index.

CFTC Rules Impact on Private Investment Funds

- **CPO Registration—Process**

- The CPO Itself
 - Must File Form 7-R through the NFA's Online Registration System (ORS), and concurrently will become a member of the NFA.
 - Application fee of \$200; NFA annual membership dues of \$750.
- “Associated Persons” of the CPO
 - Generally, any person that solicits investors (and supervisors thereof).
 - Must register with the CTFC on Form 8-R, and become an “associate member” of the NFA
 - \$85 application fee; must submit a fingerprint card for an FBI background check.
 - *Must obtain Series 3 license, subject to exemptions.*

CFTC Rules Impact on Private Investment Funds

- **CPO Registration—Process**

- “Principals” of the CPO
 - Generally, any general partner, managing member, director, executive officer and 10% owner.
 - Must file a Form 8-R through ORS.
 - \$85 application fee.
 - Must submit a fingerprint card for an FBI background check (except for “outside directors”).
 - Not considered to be registered with the CFTC or members of the NFA; rather, they are “listed” as Principals of the registered CPO.

CFTC Rules Impact on Private Investment Funds

- **CPO Registration—Ongoing Obligations**

- Disclosure

- A “Disclosure Document” for pool participants must be prepared in accordance with Rules 4.24 and 4.25 and must accompany subscription documents.
- *The Disclosure Document must be accepted by the NFA prior to use.*

- Reporting

- Distribute to investors unaudited monthly “Account Statements” within 30 days of each month end.
- Distribute to investors and file with the NFA audited “Annual Reports” within 90 days after each year end (subject to extension requests).
- Annual CFTC registration update.
- Annual NFA questionnaire.

CFTC Rules Impact on Private Investment Funds

- **CPO Registration—Ongoing Obligations**

- Reporting (cont.)
 - File Form CPO-PQR
 - CPOs divided into “small” (less than \$150 million), “medium” (between \$150 million and \$1.5 billion) and “large” (greater than \$1.5 billion).
 - Small CPOs: file NFA Form PQR on quarterly basis within 60 days of the quarters ending March, June & September. Also required to file a year-end report (Schedule A & schedule of investments) within 90 days of the calendar year end.
 - Medium CPOs: file NFA Form PQR on a quarterly basis within 60 days of the quarters ending in March, June & September. Also required to file CFTC Form CPO-PQR’s Schedules A & B annually, within 90 days of the calendar year end.

CFTC Rules Impact on Private Investment Funds

- **CPO Registration—Ongoing Obligations**

- Reporting (cont.)
 - Large CPOs: file CFTC Form PQR schedules on a quarterly basis within 60 days of the quarter end. CPOs that file Form PF with the SEC in lieu of CFTC Form CPO-PQR required to file NFA Form PQR with NFA on a quarterly basis within 60 days of the quarter end, except for December 31st quarter, which will be due within 90 days of quarter end.
- Recordkeeping
 - Must make and keep prescribed records in an accurate, current and orderly manner at main business office.
 - Keep for 5 years; must be readily accessible for 2 years.
 - Open to inspection by DOJ and CFTC.

CFTC Rules Impact on Private Investment Funds

- **CPO Registration “Lite”**

- A Section 4.7 exemption provides relief from many of the requirements of a registered CPO, effectively substituting significantly less onerous requirements.
- Requires that every investor in the fund be a “qualified eligible person” (“QEP”).
- A QEP includes an entity with total assets in excess of \$5 million or an individual that is an accredited investor, provided, in each case, that the person owns securities of issuers not affiliated with such person and other investments with an aggregate market value of at least \$2 million.

Thank you for participating in the webinar. If you have any questions, please contact:

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