Chapter 5

Fund Regulation

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§ 5:1 Avoiding Investment Company Status

Section 3(a)(1) of the Investment Company Act of 1940 defines an investment company as any issuer of securities which “is or holds itself out as being engaged primarily or proposes to engage primarily, in the business of investing, reinvesting or trading in securities.”1 Section 7(a) of the Investment Company Act generally prohibits an investment company from engaging in the business of buying and selling securities unless it has registered with the SEC or has a valid exemption from registration. A hedge fund, whether organized domestically or offshore, that invests or trades in securities or security futures falls squarely within the definition of “investment company.” Absent an applicable exception from this definition, an investment company will be subject to registration under the Investment Company Act. However, registration of the fund under the Investment Company Act would, in many cases, seriously inhibit the fund’s operations by subjecting it to extensive statutory and regulatory requirements imposed on registered funds. These include provisions

(1) requiring a registered fund to have a board of directors, a portion of which must be disinterested,2

(2) proscribing certain affiliated transactions which might otherwise be permissible with disclosure to and the consent of investors,3

(3) limiting the amount of leverage that the fund can use,4 and limiting its ability to engage in short sales and to invest and trade in futures, options, and other derivatives.

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2. 15 U.S.C. § 80a-10(a) [providing that no registered investment company may have a board of directors more than 60% of whose members are persons who are “interested persons of such registered company.”]. See also Investment Company Act Rel. No. 26,520 (July 27, 2004) [adopting amendments to rules under the Investment Company Act to require registered investment companies that rely on certain exemptive rules to have boards of which at least 75% of whose members are independent]; but see Investment Company Act Rel. No. 27,395 (June 13, 2006) [reopening rule changes for further comment].
3. 15 U.S.C. § 80a-17(d); 17 C.F.R. § 270.17d-1(a) [making it unlawful for any affiliated person of or principal underwriter for a registered investment company, or any affiliated person of such a person or principal underwriter, to engage in any transaction in which the registered investment company, or a company controlled by the registered investment company, jointly participates without obtaining prior SEC approval by exemptive application].
It is therefore often critical to organize and operate a hedge fund to enable it to avoid registration under the Investment Company Act.

Offshore funds seeking to market their securities to U.S. investors or in the United States must also be cognizant of the Investment Company Act. Section 7(d) of the Investment Company Act prohibits a foreign investment company from making a public offering of its shares in the United States through U.S. jurisdictional means unless the SEC issues an order permitting it to register under the Investment Company Act.\(^5\) Such an order must be based on a finding by the SEC that “it is both legally and practically feasible effectively to enforce the provisions” of the Investment Company Act against the offshore fund and that “the issuance of such order is otherwise consistent with the public interest and the protection of investors.”

As a practical matter, the standard imposed by section 7(d) requires offshore funds to organize and operate themselves as registered investment companies, which has prevented most offshore funds from obtaining the necessary SEC order. Consequently, offshore hedge funds wishing to offer their securities in the United States must do so through a private placement and avoid registration under the Investment Company Act.

\section*{§ 5:1.1 Section 3(c)(1) Funds}

Relief from registration for both domestic and offshore funds is provided under two provisions of section 3(c) of the Investment Company Act, which delineates a series of exceptions from the definition of investment company. These “private investment company” exceptions are contained in sections 3(c)(1) and 3(c)(7).\(^6\) Section 3(c)(1) excepts from the definition of investment company a fund that meets two requirements: it must be an “issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons” and one “which is not making and does not presently propose to make a public offering of its securities.”\(^7\) The theory behind this exception is that, in the absence of a public

\begin{itemize}
\item 5. 15 U.S.C. § 80a-7(d).
\item 6. Relief from registration afforded by these two statutory provisions effectively relieves funds from regulation under the Investment Company Act. However, they will be subject to provisions of the Investment Company Act, which precludes an unregistered fund from purchasing or otherwise acquiring shares of a registered investment company to the extent that, immediately after such purchase or acquisition, the unregistered fund will own more than 3% of the outstanding voting securities of the registered investment company. 15 U.S.C. §§ 80a-3(c)(1), -3(c)(7)(D) and -12(d)(1).
\item 7. 15 U.S.C. § 80a-3(c)(1).
\end{itemize}
offering of its securities, a small investment pool falls outside of the
purview of the Investment Company Act.\(^8\) With respect to offshore
funds, the SEC has integrated sections 7(d) and 3(c)(1), stating that an
unregistered offshore fund can make a private offering in the United
States concurrently with a public offering outside the United States
and not violate section 7(d), provided that the offshore fund has no
more than 100 beneficial owners resident in the United States.\(^9\) Where
ownership of an offshore fund is held in an account by a U.S. fiduciary
for the benefit of non-U.S. persons, such accounts are not counted
towards the 100-beneficial-owner threshold.\(^10\) A domestically orga-
nized 3(c)(1) fund must count all investors, both domestic and foreign,
towards the 100-beneficial-owner limitation. Section 3(c)(1) is self
executing, requiring no filing by the fund, as long as its two require-
ments are met.\(^11\)

[A] The 100-Beneficial-Owner Requirement

Application of the beneficial owner limitation to individuals is
relatively straightforward. Each hedge fund investor is generally
counted as a single beneficial owner. Each natural person will be
counted as a single owner. Joint ownership by spouses will, however,
be considered held by one beneficial owner.\(^12\) Where an entity is an
investor, the fund need not count other entities that invest if they have
identical ownership or beneficiaries. The fund, if organized as a
limited partnership or limited liability company, need not count the

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8. Protecting Investors: A Half-Century of Investment Company Regulation,
SEC Staff Report, 105-106 (May 1992).
11. Since the private placement requirement is generally met through adher-
ence to a Rule 506 offering under Regulation D, the fund must still make
the filing required under that regulation and notice filings in certain states
where the fund’s securities are sold. See chapter 4.
if a husband and wife each owns securities of a section 3(c)(1) fund in his or
her own name, the fund will be required to count the husband and wife as
two beneficial owners, whereas if the securities are jointly held by the
husband and wife, they should be counted as one beneficial owner.
American Bar Association Section of Business Law, SEC No-Action Letter
(Apr. 22, 1999), Question I.1. Similarly, where a husband and wife own an
entity that invests in the section 3(c)(1) fund and that investing entity is
subject to the section’s 10% “look through” provision discussed below, the
entity will be treated as two beneficial owners if the husband and wife each
own their respective interests in the investing entity in their own names,
while it will be treated as a single investor if they own the entity’s
securities jointly. Id. at Question I.2.
general partner or managing member towards the 100-person limit as the interest they hold in the fund is not considered a security.\footnote{Shoreline Fund, L.P. and Condor Fund International, Inc., SEC No-Action Letter (Nov. 14, 1994). However, section 48(a) of the Investment Company Act, which prohibits doing indirectly what is prohibited directly, would preclude funneling additional investors into the fund through a general partner or managing member entity.}

[b] Knowledgeable Employees

In addition, one need not count investors who are “knowledgeable employees” at the time they invest. A knowledgeable employee is defined to include an executive officer,\footnote{An executive office includes the president, any vice president in charge of a principal business unit, division or function (such as sales, administration or finance), and any other officer who performs a policy-making function for the fund or its manager.} director, trustee, general partner, advisory board member or person serving in a similar capacity of the fund, or its manager.\footnote{17 C.F.R. § 270.3c-5.} In addition, it includes an employee of the fund or its manager who, in connection with his or her regular functions or duties, participates in the investment activities of the fund or other funds managed by the same manager, and who has been so engaged in investment activities for the fund or its manager, or engaged in substantially similar functions for another firm, for at least twelve months. An investor retains his or her knowledgeable employee status even if his or her employment with the fund or its manager is terminated. Moreover, an employee who is not a knowledgeable employee when first invested with the fund, but who subsequently becomes a knowledgeable employee, need no longer be counted towards the 100-beneficial-owner threshold.\footnote{American Bar Association Section of Business Law, SEC No-Action Letter (Apr. 22, 1999), Questions A.6, A.7.} If spouses invest jointly in a fund, and one of the spouses is a knowledgeable employee, both will be considered knowledgeable employees.\footnote{Id. at Question A.4.} In addition, a company owned exclusively by knowledgeable employees of the fund or its manager will itself be a knowledgeable employee of the fund. Likewise, a “family investment company,” in which a knowledgeable employee of the fund or its manager has sole authority to make investment decisions, and whose assets consist only of assets that were owned by the knowledgeable employee or jointly with such employee’s spouse, prior to their contribution to the family investment company, will also be a knowledgeable employee of the fund.\footnote{Id.} An investing entity that is
the “alter ego” of a knowledgeable employee (where the entity is wholly owned by the employee, the employee makes all of the decisions with respect to its investments, and the investments are for the benefit of the employee) will be considered to be the investment of the knowledgeable employee. The IRA of a knowledgeable employee will therefore not be counted towards the 100-beneficial-owner ceiling.  

The knowledgeable employee rule specifically excludes employees who perform clerical, secretarial or administrative functions. Moreover, officers or employees who do not fall within the categories enumerated by the rule are generally unable to qualify as knowledgeable employees. Consequently, financial, operational, compliance, and marketing personnel, who may in fact have extensive knowledge concerning the fund and its manager, will usually not be deemed knowledgeable employees under the rule, unless they are executives who run a business unit or who have policy making responsibilities as contemplated by the definition of executive officer. Even a member of the manager’s research department will be excluded unless the member has portfolio-wide responsibilities. The burden of proof lies with the hedge fund with respect to knowledgeable employee status.

[C] Involuntary Transferees

Rule 3c-6 under the Investment Company Act prevents certain involuntary transfers of interests in a fund from inadvertently causing it to exceed 100 beneficial owners. This rule provides generally that beneficial ownership in a section 3(c)(1) fund by a transferee who acquired those interests pursuant to a gift, bequest or an agreement relating to a legal separation or divorce will be deemed beneficially owned by the transferor, thereby not causing a change in the number or character of the fund’s beneficial owners, provided that the transferee is the estate of the transferor, a donee (as defined in the Rule), or a company established by the transferor exclusively for the benefit of or owned exclusively by the transferor and/or donee or the estate of the transferor. Conversely, Rule 3c-6 will not apply if a person acquires the securities of a section 3(c)(1) fund for consideration; such a transferee would be counted towards the 100-beneficial-owner limit.

In addition, offshore funds need not register under the Investment Company Act as a result of certain secondary market transactions in their interests, changes in the residency of a beneficial owner, or other situations that they do not control.

19. Id. at Question 8.
20. Id.
21. 17 C.F.R. § 270.3c-6.
[D] Look-Through Rule

An entity that is not a public or private investment fund may own any amount of a section 3(c)(1) hedge fund and will count as one beneficial owner for purposes of the 100-person limit. However, to prevent circumvention of the 100-beneficial-owner limit through the layering of one investment pool over another, section 3(c)(1)(A) contains a “look-through” provision that requires a look-through of any investment company (including those excepted from the definition by sections 3(c)(1) and 3(c)(7)) that owns 10% or more of the outstanding voting securities of the section 3(c)(1) fund, and requires counting the holders of such entities’ outstanding securities as the beneficial owners of the fund.\(^\text{23}\) The analysis of whether the look-through provision applies is made each time an investor acquires voting securities.\(^\text{24}\)

Generally, interests or relationships that give a security holder the ability to control or influence a fund’s operations or management may be considered “voting securities.” Interests in limited partnerships or limited liability companies that permit holders of those interests to remove or replace the general partner or managing member may therefore be deemed voting securities.\(^\text{25}\) Moreover, even absent explicit voting rights, having a significant stake in a fund that effectively permits the holder to exercise control over a fund’s management may also be deemed a voting security.\(^\text{26}\) The look-through requirement does not apply to investing entities that are not investment companies or 3(c)(1) or 3(c)(7) funds, and such entities may hold more than 10% of a hedge fund and still be counted as a single beneficial owner.

23. The current “look-through” provision was adopted as part of the National Securities Market Improvements Act of 1996. Prior to its adoption, any entity owning 10% or more of a private investment company was deemed to be a single beneficial owner only if the value of all of its holdings in section 3(c)(1) excluded investment companies did not exceed 10% of the investing entity’s assets (commonly referred to as the “second 10% test”). The SEC adopted Rule 3c-1 to continue to treat an investment company as a single beneficial owner even if it owns 10% or more of the outstanding voting securities of the private investment company, provided that such ownership existed on or before April 1, 1997, and that the investing entity satisfied and continues to satisfy the second 10% test. See 17 C.F.R. § 270.3c-1.

24. See Investment Company Act Rel. No. 22,597 n.19 (Apr. 3, 1997). It should be noted that if an entity subject to the look-through requirement is at or below a 10% ownership level, and has its ownership percentage increase due to withdrawals of capital by other investors, a look-through will not be triggered as long as the entity has not also acquired additional voting securities at that time.


Even where a look-through would not be mandated by the language of section 3(c)(1), other factors may necessitate a look-through and count of the individual beneficial owners of certain investing entities. Thus, where an investment fund is organized specifically for the purpose of investing in the hedge fund, it will be looked-through. The SEC staff will generally not view an entity as having been formed for the purpose of investing in a section 3(c)(1) fund if the investing entity invests less than 40% of its assets in the section 3(c)(1) fund. However this 40% test is not a statutory requirement and a failure to adhere to it will not automatically require a look-through where the facts and circumstances support a different conclusion. Similarly, if the individual owners of the investing entity can decide whether or how much of their own capital contribution to that entity may be invested in the hedge fund, a look-through will often apply. Thus a defined contribution plan that is managed in such a way to facilitate the individual investment decisions of its participants will be looked-through and each participant counted for purposes of section 3(c)(1). However, a plan managed by a plan fiduciary, where investments in a section 3(c)(1) fund are made through an account with a generic investment objective, the plan may be treated as a single beneficial owner.

[E] Private Placement Requirement

The private placement requirement of section 3(c)(1) is met if the offering of securities by the fund is a non-public offering under section 4(2) of the Securities Act or comports with Rule 506 of Regulation D. It should be noted that in order to satisfy this second requirement of section 3(c)(1), in addition to offering the fund’s securities privately, the fund must also not be “presently proposing” to make a public offering.

Hedge funds typically employ certain procedures to ensure they comply with the requirements of section 3(c)(1). In order to stay

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within the 100-beneficial-owner requirement, they closely monitor the number and type of investors. Moreover, they often will include in their subscription agreements representations to enable them to identify entity investors as being investment companies or section 3(c)(1) or section 3(c)(7) funds, so that they can guard against having those types of investors exceed a 10% ownership stake. Careful adherence to the requirements of Rule 506 of Regulation D is also needed to meet the private placement requirement. Offering materials and subscription agreements will contain appropriate legends and restrictions on transfers of hedge fund interests as required by Regulation D.

§ 5:1.2 Section 3(c)(7) Funds

The second available exception from the definition of investment company, that provided by section 3(c)(7) of the Investment Company Act, applies to any issuer, the outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are “qualified purchasers,” and which is not making and does not at the time propose to make a public offering of such securities.33 As is the case with a section 3(c)(1) fund, this exemption does not require any filing, although federal and state filings in connection with making the required private placement of the funds interests must be made. Absent the desire of hedge funds to avoid registration of their securities under the Exchange Act, discussed later in this chapter, a section 3(c)(7) fund could, in theory, have an unlimited number of qualified purchasers.

[A] Qualified Purchasers

Qualified purchasers are intended to be investors with sufficient sophistication in financial affairs34 by virtue of falling within one of four categories:

1. any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in a section 3(c)(7) fund with that person’s qualified purchaser spouse) who owns not less than $5 million in investments;

2. any company (referred to as a “family-owned company”) that owns not less than $5 million in investments and that is

34. S. Rep. No. 293, 104th Cong., 2d Sess. 10 (1996) (“Generally, these investors can evaluate on their own behalf matters such as the level of a fund’s management fees, governance provisions, transactions with affiliates, investment risk, leverage and redemption rights.”).
directly or indirectly owned by or for two or more natural persons who are related as siblings or spouses (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons or foundations, or charitable organizations or trusts established by or for the benefit of such persons;

(3) any other trust that was not formed for the specific purpose of acquiring the securities of the section 3(c)(7) fund and as to which the trustee and each settlor or other person contributing assets to the trust are qualified purchasers; and

(4) any person acting for his own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis not less than $25 million in investments.

Consistent with the discussion above regarding alter ego entities of knowledgeable employees, when an entity, such as an IRA or self-directed account of a retirement plan, is the alter ego of the investor and the investor is a qualified purchaser, such entity will be treated as a qualified purchaser.\textsuperscript{36} A company formed to invest in a section 3(c)(7) fund will not be a qualified purchaser unless all of its owners are qualified purchasers.\textsuperscript{37} This prevents the formation of an entity for the specific purpose of enabling investors, who are not themselves qualified purchasers, to invest in a section 3(c)(7) fund. The SEC staff, in discussing this prohibition, noted that it arises from the language found in section 2(a)(51)|A|(iii) of the Investment Company Act and its related Rule 2a51-3, both of which prevent entities from being “formed” for the purpose. Interestingly, it went on to emphasize that section 48 of the Investment Company Act, which prohibits an entity from doing indirectly that which it is prohibited from doing directly, applies both to entities that are formed “or operated” for the purpose of circumventing the Investment Company Act, concluding that

while an entity that is operated for the specific purpose of acquiring securities in a Section 3(c)(7) Fund may nevertheless still be considered a qualified purchaser under Section 2(a)(51)|A|, that entity and the Fund may be in violation of Section 48(a).\textsuperscript{38}

“Qualified Institutional Buyers” (QIBs) as defined by Rule 144A under the Securities Act are, with two exceptions, deemed to be

\begin{itemize}
  \item \textsuperscript{35} 15 U.S.C. § 80a-2(a)|51|A|.
  \item \textsuperscript{36} American Bar Association Section of Business Law, SEC No-Action Letter [Apr. 22, 1999] Question A.8.
  \item \textsuperscript{37} 17 C.F.R. § 270.2a51-3.
  \item \textsuperscript{38} American Bar Association Section of Business Law, SEC No-Action Letter [Apr. 22, 1999] Question D.5.
\end{itemize}
qualified purchasers. Rule 144A generally defines a QIB as certain institutions that own and invest on a discretionary basis $100 million of securities of issuers that are not affiliated with the institution ("QIB Securities"), banks that own and invest on a discretionary basis $100 million of QIB Securities and have an audited net worth of at least $25 million, and certain registered dealers that own and invest on a discretionary basis $10 million of QIB Securities. The first exception pertains to dealers and coordinates the definition of QIB with that of qualified purchaser by requiring the dealer to own and invest on a discretionary basis $25 million of QIB Securities. The second exception pertains to self-directed employee benefit plans and requires each participant in such a plan to be a qualified purchaser if the plan itself is to be considered a qualified purchaser.39

A hedge fund seeking section 3(c)(7) status need only have a reasonable belief that an investor is a qualified purchaser based upon the investor’s representations. The investor’s status must be assessed each time the investor acquires securities of the fund, unless subsequent acquisitions are made pursuant to a binding agreement requiring installment payments or periodic capital calls. Thus, the determination of the qualified purchaser status of a trustee of a trust investing in a section 3(c)(7) fund is made when the trustee makes the decision to acquire the securities issued by the fund.40 In the case of the settlor of a trust, the determination of the settlor’s status as a qualified purchaser is made at the time the settlor contributes assets to the trust.41

[B] Knowledgeable Employees

A section 3(c)(7) fund’s knowledgeable employees, as defined in Rule 3c-5 discussed above, may invest in the fund without regard to whether they are themselves qualified purchasers. Moreover, a spouse who is not a qualified purchaser or a knowledgeable employee can hold a joint interest in a section 3(c)(7) fund with his or her knowledgeable employee spouse.42

[C] Involuntary Transferees

Similarly, a fund may admit transferees in accordance with Rule 3c-6 discussed above, even if they are neither qualified purchasers or knowledgeable employees of the fund or its manager. Transferees who acquire fund securities for consideration will not be eligible for Rule 3c-6 treatment and must be qualified purchasers.

39. Id. at Question A.4.
40. Id. at Question C.1.
41. Id.
42. Id.
All of the investors in a domestic section 3(c)(7) fund, whether domestic or foreign, must be qualified purchasers, knowledgeable employees, or permissible involuntary transferees.

[D] Investments

Investments, for purposes of the definition of qualified purchasers, are defined broadly in Rule 2a51-1 under the Investment Company Act and include most securities, real estate, commodity interests, physical commodities, financial contracts, and cash and cash equivalents held for investment purposes. In particular Rule 2a51-1 lists the following as investments:

- Securities as defined by section 2(a)(1) of the Securities Act, other than securities of an issuer that controls, is controlled by, or is under common control with, the prospective qualified purchaser that owns such securities, unless the issuer of such securities is an:
  - “Investment Vehicle” which includes a registered investment company, a company excluded from the definition of investment company under sections 3(c)(1) through 3(c)(9) of the Investment Company Act or the exemptions provided by Rules 3a-6 or 3a-7 under the Investment Company Act, or a commodity pool;
  - “Public Company” which includes either a company that files reports pursuant to section 13 or 15(d) of the Exchange Act, or has a class of securities listed on a “designated offshore securities market” as defined by Regulation S, or
  - A company with shareholders’ equity of not less than $50 million (determined in accordance with generally accepted accounting principles) as reflected on the company’s most recent financial statements, provided that such financial statements present information as of a date within sixteen months preceding the date on which the prospective qualified purchaser acquires the securities of a section 3(c)(7) fund.
- Real estate held for investment purposes. This excludes real estate if it is used by the prospective qualified purchaser or a related person for personal purposes or as a place of business.

43. 17 C.F.R. § 270.2a51-1.
44. 17 C.F.R. § 270.2a51-1(a)(3), (a)(7), (b)(1).
Real estate owned by a prospective qualified purchaser who is engaged primarily in the business of investing, trading or developing real estate in connection with such business may be deemed to be held for investment purposes. Residential real estate will not be deemed to be used for personal purposes if deductions with respect to such real estate are not disallowed by section 280A of the Internal Revenue Code.  

- Commodity interests and physical commodities held for investment purposes. This includes commodity futures contracts, options on commodity futures contracts, and options on physical commodities traded on or subject to the rules of (1) any contract market designated for trading such transactions under the Commodity Exchange Act and its rules, or (2) any board of trade or exchange outside the United States, as contemplated in Part 30 of the rules of the Commodity Exchange Act, as well as physical commodities with respect to which a commodity interest is traded on such contract market, board of trade or exchange. Commodity interests or physical commodities owned, or financial contracts entered into, by a prospective qualified purchaser who is engaged primarily in the business of investing, reinvesting or trading in such interests, physical commodities or contracts in connection with such business may be deemed to be held for investment purposes.  

- Financial contracts as defined in section 3(c)(2)(B)(ii) of the Investment Company Act entered into for investment purposes. This would include swaps and repurchase agreements.  

- Amounts payable to a section 3(c)(1) fund, section 3(c)(7) fund or commodity pool pursuant to a firm agreement or binding commitment to acquire an interest in or make a capital contribution to such entities upon demand.  

- Cash and cash equivalents (including foreign currencies) held for investment purposes, including bank deposits, certificates of deposit, bankers acceptances and similar bank instruments held for investment purposes, and the net cash surrender value of an insurance policy. 

45. 17 C.F.R. § 270.2a51-1(b)(2), (c)(1).  
46. 17 C.F.R. § 270.2a51-1(a)(1), (a)(5), (b)(3), (b)(4), (c)(2).  
47. 17 C.F.R. § 270.2a51-1(b)(5).  
48. 17 C.F.R. § 270.2a51-1(b)(6).  
49. 17 C.F.R. § 2a51-1(b)(7).
As the foregoing indicates, certain holdings are excluded from the definition of investment, as their ownership is not deemed to evidence the level of financial sophistication necessary to invest in an unregistered investment company. Thus, securities that constitute a “control interest” in an issuer (typically a family-owned or closely held business) are excluded, as is real estate used for one’s personal residence or place of business. However, where a controlling securities interest evidences such sophistication, including controlling interests in private investment companies, brokers, banks, insurance companies, finance companies, and certain structured finance vehicles, as well as in public operating companies filing periodic reports under the Exchange Act and large private operating companies with shareholders’ equity of $50 million or more, such controlling interests may be treated as investments.

The valuation of investments may be based either on their fair market value on the most recent practicable date or cost.\(^{50}\) In the case of commodity interests, the amount of investments will be the value of the initial margin or option premium deposited in connection with the commodity interest. With respect to any investment, the valuation must deduct the amount of any outstanding indebtedness incurred to acquire the investment.\(^{51}\)

Rule 2a51-1 also addresses how qualified purchaser status is assessed under certain investment ownership arrangements.\(^{52}\) Where a natural person owns an investment jointly with his or her spouse, or shares with such person’s spouse a community property or similar shared ownership interest, such investment may be included in the amount of the person’s investments for purposes of assessing qualified purchaser status. Where spouses make a joint investment in a section 3(c)(7) fund, there may be included in the amount of each spouse’s investments any investments owned by the other spouse, regardless of whether those investments are held jointly. In calculating the investments of a company, one may include investments owned by majority-owned subsidiaries of the company and investments of the company’s parent, if the parent is the majority owner of the company, as well as investments of other majority-owned subsidiaries of the parent. Any investments held in an IRA or similar retirement account that is directed by and held for the benefit of a natural person can be included in determining the amount of investments held by that person.

\(^{50}\) 17 C.F.R. § 2a51-1(d).
\(^{51}\) 17 C.F.R. § 2a51-1(e).
\(^{52}\) 17 C.F.R. § 2a51-1(g)(2)–(4).
[E] The Private Placement Requirement

The private placement requirement of section 3(c)(7) is met if the offering of securities by the fund is a non-public offering under section 4(2) of the Securities Act or comports with Rule 506 of Regulation D.53

[F] Numerical Limits on Section 3(c)(7) Funds

Unlike section 3(c)(1), which has a numerical ceiling on the number of beneficial owners permitted, no such limitation is imposed by section 3(c)(7). Notwithstanding this, there are essentially three considerations which result in the number of investors in a section 3(c)(7) fund being effectively limited.

[F][1] Securities Exchange Act Reporting

First, section 12(g) of the Securities Exchange Act of 1934 requires domestic issuers of securities, with total assets exceeding $10 million and a class of equity securities held of record by 500 or more persons, to register such class of securities under the Exchange Act, absent an exemption from registration. Exchange Act registration would subject a hedge fund to the periodic reporting requirements of the Exchange Act, which would be administratively burdensome. Consequently, at present, domestic hedge funds are effectively limited to having no more than 499 investors.

Rule 12(g)-1(a) under the Exchange Act states that “securities shall be deemed to be ‘held of record’ by each person who is identified as the owner of such securities on the records of the security holders maintained by or on behalf of the issuer.” It goes on to provide that “securities identified as held of record by a corporation, a partnership, a trust . . . or other organization shall be included as so held by one person.” Thus, as a general rule, an issuer need not look through record ownership to the beneficial holders of the record holder in determining whether the issuer has over 500 security holders for purposes of registration under section 12(g) of the Exchange Act.53.1

However, Rule 12(g)-1(b) provides that notwithstanding this general rule, “if the issuer knows or has reason to know that the form of holding securities of record is used primarily to circumvent the provisions of section 12(g) . . . of the Act, the beneficial owners of such securities shall be deemed to be the record owners thereof.”

53. Investment Company Act Rel. No. 22,597, n.5 [Apr. 3, 1997] (stating the SEC’s belief that the public offering limitation in section 3(c)(7) should be interpreted in the same manner as the limitation in section 3(c)(1)).

Another potential limitation on the number of investors in a fund is found in the federal tax code. As we have discussed previously, domestic hedge funds are typically structured as partnerships for tax purposes so as to avoid the second level of tax imposed on corporations. Under Internal Revenue Code section 7704 and related regulations, a partnership with more than 100 investors will be treated as a "publicly traded partnership" and taxed as a corporation if interests in the partnership are traded on an established securities market or a secondary market or the substantial equivalent of such a market. A hedge fund may be subject to publicly traded partnership status if it affords liquidity to its investors sufficient to be viewed as having created a secondary market in its interests. A partnership, even if publicly traded, will not be taxed as a corporation if 90% or more of its gross income constitutes "qualifying income." In general, investment-type income is qualifying income, but certain types of hedge fund income—for example, fees earned from mezzanine financings—do not qualify. Accordingly, there are three means of avoiding corporate tax status:

- limit income to "qualifying income";
- limit investor withdrawals so as not to provide liquidity equivalent to a secondary market; or
- limit the number of investors to 100.

Plan Asset Regulations

A third numeric ceiling of which hedge funds must be cognizant is that discussed in chapter 7 relating to the Plan Asset Regulations under ERISA. As discussed, hedge funds seeking to avoid falling under the Plan Asset Regulations do so by ensuring that equity participation in the fund by "benefit plan investors" is not significant. This requires that such investors not hold, in the aggregate, 25% or more of any class of equity interest in the fund.

§ 5:1.3 The Interplay of Sections 3(c)(1) and 3(c)(7)

A number of hedge fund managers may begin operating by raising capital from "friends and family" and may therefore do so through a section 3(c)(1) fund, as many of its initial investors may not be able to meet the qualified purchaser standards. As the business of a successful manager matures, many will begin to access capital from qualified purchasers. Moreover, as the number of investors grows, the hedge fund may begin bumping up against the 100-beneficial-owner ceiling. Consequently, it is not uncommon to see such managers convert their section 3(c)(1) fund into a section 3(c)(7) fund.
[A] Conversion

Section 3(c)(7)(B) requires the converting fund to notify each of its beneficial owners of its intention to convert and to inform them that, going forward, ownership of the fund will no longer be limited to 100 persons and that all future investors will be limited to qualified purchasers and knowledgeable employees. Any current investor in the fund who is not otherwise a qualified purchaser or knowledgeable employee must be mandatorily redeemed, and each investor eligible to remain as an investor post-conversion must be afforded a reasonable opportunity to redeem any or all of the investor’s interest in the fund for that beneficial owner’s proportionate share of the fund’s net assets. The redemption must be made in cash, although the fund may offer investors the option to receive all or a portion of their share in assets of the fund.

[B] Integration

A hedge fund manager may operate identical section 3(c)(1) and section 3(c)(7) funds without having to “integrate” the two funds. If they were to be integrated, and therefore treated as if they were one fund, the section 3(c)(1) fund would disqualify the section 3(c)(7) fund, as it would be deemed to have non-qualified purchaser investors, and the section 3(c)(1) fund might also be unable to satisfy its exception if the combined number of beneficial owners of the two funds exceeded 100. Thus, even if the two funds are managed in a similar fashion, they will not be integrated for purposes of determining their respective compliance with their applicable exception from the definition of investment company.

Integration is however a major concern when dealing with two or more section 3(c)(1) funds. Consequently, a hedge fund manager cannot circumvent section 3(c)(1) by creating multiple 3(c)(1) funds, none of which individually exceed the 100-beneficial-owner limitation but which in the aggregate exceeds that threshold, unless they are truly different. The SEC will look at factors including the strategies pursued by the funds, their portfolios, their risk/return characteristics, and whether the two funds are intended for two distinct groups of investors to determine if an investor would view them as being engaged in

54. Section 3(c)(7) was enacted in 1996 and provides a mechanism by which a section 3(c)(1) fund existing on or before September 1, 1996 can convert into a section 3(c)(7) fund without requiring investors who acquired their interests in such “grandfathered” section 3(c)(1) fund on or before September 1, 1996, and who are neither qualified purchasers or knowledgeable employees, to dispose of their interests.

essentially the same type of investment program.\textsuperscript{56} Where two funds are used to appeal to taxable and tax-exempt investors, the SEC has found this to be a sufficient distinction.\textsuperscript{57} However, if the funds lack the requisite distinctiveness, they will be integrated and treated as if they were one fund, and all investors in these funds will be aggregated for purposes of determining the number of investors. Thus, the SEC issued an administrative order and brought cease-and-desist proceedings against two registered investment advisers where two funds had very similar investment strategies and, in practice, held nearly identical portfolios, resulting in a finding that they should be integrated, which in turn resulted in the integrated funds having 112 investors in violation of section 3(c)(1).\textsuperscript{58} Moreover, the SEC does not believe that the statutory prohibition against integrating a 3(c)(1) fund and a 3(c)(7) fund was intended to permit a fund manager to use section 3(c)(7) to circumvent the 100-beneficial-owner limitation by simply converting an existing 3(c)(1) fund into a 3(c)(7) fund and thereafter establishing a new 3(c)(1) fund, unless the conversion was done with a bona fide purpose of seeking to raise capital from qualified purchasers. The determination of whether a conversion is bona fide and undertaken in good faith is a facts and circumstances test. The SEC stated that such facts will include whether the newly converted 3(c)(7) fund has taken steps to sell its securities to qualified purchasers and whether it is subject to restrictions that would prevent it from making such sales.\textsuperscript{59} The SEC retains the ability under section 48(1) of the Investment Company Act, which prohibits a person from doing indirectly what cannot be done directly, to prevent the use of creative transactions or complex structures to evade the requirements of sections 3(c)(1) and 3(c)(7).\textsuperscript{60}

\section*{§ 5:1.4 Combined Domestic and Offshore Fund Structures}

As we have seen, many hedge fund managers simultaneously operate or advise multiple funds, including both domestic and offshore funds. These multiple fund structures often take the form of a parallel approach or a master-feeder structure.\textsuperscript{61}

\begin{itemize}
\item \textsuperscript{56} Shoreline Fund, L.P., SEC No-Action Letter [Apr. 11, 1994], and other letters cited therein.
\item \textsuperscript{57} \textit{Id}.
\item \textsuperscript{59} Investment Company Act Rel. No. 22,597 [Apr. 3, 1997], Part II D.
\item \textsuperscript{61} See chapter 2, section 2:5.
\end{itemize}
From an Investment Company Act perspective, the structuring of a fund complex that includes both domestic and offshore funds must take into account the following rules that have been discussed above:

- A domestic section 3(c)(1) fund is limited to 100 beneficial owners, whether they are U.S. or non-U.S. investors.

- An offshore fund is prohibited from making a public offering in the United States pursuant to section 7(d) of the Investment Company Act. However, it may simultaneously raise capital in the United States in a private offering in reliance on section 3(c)(1) and conduct a public offering of its securities outside of the United States if its U.S. private offering does not result in it having more than 100 beneficial owners residing in the United States.62

- If the domestic fund is a section 3(c)(1) fund and the offshore fund raises its U.S. capital in reliance on section 3(c)(1), and if these two funds are operated in a manner that would subject them to integration, then the investors in the domestic fund will be added together with the investors, both U.S. and non-U.S., in the offshore fund to see if each fund is in compliance with the 100 beneficial owner limitation.

- A domestic section 3(c)(7) fund is limited to beneficial owners, who are qualified purchasers, knowledgeable employees, or permitted transferees, whether they are U.S. or non-U.S. investors.

- An offshore fund may simultaneously raise capital in the United States in a private offering in reliance on section 3(c)(7) and conduct a public offering of its securities outside the United States if its U.S. private offering does not result in it having U.S. investors who are not qualified purchasers, knowledgeable employees, or permitted transferees.63

As discussed in chapter 2, two typical hedge fund structures that accommodate both domestic and offshore funds are a parallel structure and a master-feeder structure. In the case of a parallel structure, provided that the domestic and offshore funds are not integrated, each can have up to 100 U.S. beneficial owners.

In a master-feeder structure, the master fund is often organized offshore. As one of its investors will be a domestically organized feeder fund, it must be determined whether its offering in the United States will be made in accordance with section 3(c)(1) or section 3(c)(7).

Regardless of which exclusion it relies upon, it will need to “look through” each of its feeder funds. This is due to the fact that, if it relies on section 3(c)(1), it is likely that feeder funds will own 10% or more of the master fund and, in either case, the feeder funds are likely to be viewed as having actually been formed for the purpose of investing in the master fund, or deemed to have been so formed as they will be investing all or nearly all of their assets in the master fund, thereby exceeding the 40% rule of thumb used by the SEC staff. As a result, the feeder funds into a section 3(c)(1) master fund will be limited to having collectively no more than 100 beneficial owners (excluding knowledgeable employees), regardless of their residency or location, and the feeder funds into a section 3(c)(7) master fund will only be able to have beneficial owners who are qualified purchasers and knowledgeable employees.

As a consequence, two non-integrated section 3(c)(1) funds, one domestic and the other offshore, operated in a parallel structure, can have up to 200 U.S. beneficial owners while an offshore section 3(c)(1) master fund in a master-feeder structure will be limited to 100 U.S. beneficial owners.

Where a parallel structure has one section 3(c)(1) fund and one section 3(c)(7) fund that are not integrated, only the section 3(c)(7) fund will be required to limit its investors to qualified purchasers. However, an offshore section 3(c)(7) master fund will require all of the beneficial owners of its feeder funds to be qualified purchasers.

§ 5:2 Registering under the Investment Company Act

§ 5:2.1 Reasons for Registering

While the overwhelming majority of hedge funds use the exceptions under sections 3(c)(1) or 3(c)(7) to avoid registering under the Investment Company Act, an important change to the tax code, together with a growing desire on the part of traditional asset management firms to broaden their product lines and attract hedge fund investment dollars, has led to the development of funds that offer hedge fund-type strategies within entities registered under the Investment Company Act. While individual hedge funds have been organized as registered

64. In 1997, I.R.C. § 851(b)(3), known as the “short short rule,” was repealed. The short short rule required that mutual funds and other funds registered under the Investment Company Act derive less than 30% of their gross income from the sale of securities held for less than three months in order to qualify for Regulated Investment Company tax treatment, which enabled them to avoid an entity-level tax. With its repeal, short selling and other short-term strategies that would have previously jeopardized such funds' tax status became much more viable.
investment companies, or RICs, under the Investment Company Act, the greatest number of registrations have, to date, occurred among funds of hedge funds. The motivation to register stems from the fact that a registered fund will not be subject to either the limitation on the number of beneficial owners imposed by section 3(c)(1) nor the requirement that all of its beneficial owners be qualified purchasers under section 3(c)(7). Consequently, it affords financial services firms the opportunity to engage in a broader distribution of the fund’s securities. In addition, a registered fund will not be subject to the integration issue discussed above with respect to section 3(c)(1) funds. Investment Company Act registration also provides

(1) relief from ERISA’s plan asset rules, discussed in chapter 7, as the assets of a RIC are not treated as plan assets for purposes of ERISA,

(2) exclusion from the NASD new issue rule, discussed in chapter 8, and

(3) an exemption for the manager from CPO registration, discussed in chapter 6. \(^{64.1}\)

Moreover, if an Investment Company Act registration is coupled with a public registration of the securities of the hedge fund, the fund, in theory, could be distributed quite broadly.

\section*{§ 5:2.2 Raising Capital}

There are, however, some constraints that serve to limit the breadth and depth of registered hedge fund distributions. First, as discussed in chapter 2, hedge managers typically receive a performance-based allocation or fee. The manager of a registered hedge fund must itself be a registered investment adviser under the Advisers Act. As will be discussed in chapter 6, in order for a registered investment adviser to receive performance-based compensation from a fund that is not a section 3(c)(7) fund, the investors in the fund must be qualified clients as defined in Rule 205-3 under the Advisers Act. This will generally require them to have net worths of at least $1.5 million. In addition, as a result of the concerns expressed by the SEC over the potential

\footnote{64.1. The National Futures Association [NFA] has petitioned the Commodity Futures Trading Commission [CFTC] to amend CFTC Rule 4.5 to place limits on this exemption where a RIC engages in more than a \textit{de minimis} amount of futures trading and is offered or marketed to retail customers. Letters from Thomas W. Sexton, III, Senior Vice President and General Counsel, NFA, to David Stawick, Office of the Secretariat, CFTC [June 29, 2010 & Aug. 18, 2010].}
“retailization” of hedge funds, the SEC staff has required, as a condition of registration, that registered funds limit their offerings to investors who meet or exceed the qualified client standard. In light of these constraints, many registered funds have been offered through private placements to investors meeting or exceeding the qualified client standard, rather than through public offerings. However, unlike unregistered funds, a privately offered RIC may be sold to an unlimited number of accredited investors who meet the qualified client standard, as section 12(g)(2)(G) of the Exchange Act exempts a RIC from its registration and periodic reporting requirements, regardless of how many investors it has.

Most RICs are privately placed. Registration under the Investment Company Act is accomplished by filing with the SEC a Form N-8A along with a Form N-2.

§ 5:2.3 Closed-End, Non-Diversified Management Companies

Registered hedge funds and funds of funds are organized as closed-end non-diversified management companies. In order to understand why, a brief review of some fundamental aspects of the Investment Company Act is required. 65 The Investment Company Act divides RICs into three classes:

1. face-amount certificate companies 66 (a type of entity common at the time of the adoption of the Investment Company Act but now fairly rare);

2. unit investment trusts 67 (which generally are fixed, unmanaged pools of assets); and

3. management companies. 68 The RIC hedge fund or fund of hedge funds needs to be organized as a management company because each has an actively managed portfolio.

Management companies, in turn, generally may be divided into four categories based on two fundamental tests: a diversification test, which is functional, and a structural test based on whether the RIC is open-end or closed-end. A management company could therefore be

65. Registration under the Investment Company Act has numerous implications for a fund, and full discussion of registered full discussion of registered investment companies under the Investment Company Act is beyond the scope of this text.

66. 15 U.S.C. §§ 80a-2[a](15) and 80a-4[1].


68. 15 U.S.C. § 80a-4[3].

5—22
A company is diversified for purposes of the Investment Company Act if at least 75% of the value of its total assets is represented by cash and cash items, certain U.S. government securities, securities of other investment companies, and other securities. For purposes of this determination, the RIC may not count securities of a single issuer that account for more than 5% of the value of the RIC’s total assets or that constitute more than 10% of the voting securities of such issuer.69 A company that does not meet the Investment Company Act’s diversification test is considered a non-diversified company.70 In light of the greater flexibility with respect to portfolio construction and management afforded a fund by non-diversified status, RIC hedge funds and funds of hedge funds are non-diversified. A management company is open-end if it offers for sale or has outstanding any “redeemable security.”71 Any company that is not open-end is, by definition, closed-end.72 The term “redeemable security” is defined in section 2[a][32] of the Investment Company Act as “any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled [whether absolutely or only out of surplus] to receive approximately his proportionate share of the issuer’s current net assets, or the cash equivalent thereof.”73 This definition must be read in conjunction with section 22[e] of the Investment Company Act, which, absent unusual circumstances, requires open-end funds to redeem their shares on a daily basis and generally prohibits any RIC from postponing the date of payment upon redemption of any redeemable security in accordance with its terms for more than seven days after the tender of such security for redemption.74 “Redeemable security” must also be considered in the context of Rule 22c-1[b] under the Investment Company Act, which generally requires a company that issues a “redeemable security” to value its portfolio assets on a daily basis,75 and limits open-end companies to

69. 15 U.S.C. § 80a-5[b][1].
70. 15 U.S.C. § 80a-5[b][2].
71. 15 U.S.C. § 80a-5[a][1].
72. 15 U.S.C. § 80a-5[a][2].
73. 15 U.S.C. § 80a-2[a][32].
74. 15 U.S.C. § 80a-22[e].
75. 17 C.F.R. § 270.22c-1.
investing not more than 15% of their net assets in illiquid securities, in order to enable them to meet redemption requests.\textsuperscript{76}

In light of these provisions, a hedge fund, wishing to limit the liquidity afforded its investors in a manner consistent with industry practice, will therefore not be able or willing to register as an open-end fund. Similarly, a fund of hedge funds, whose portfolio is composed of hedge funds which do not provide daily liquidity or pricing information, necessitates closed-end status as well.

\section*{§ 5:2.4 Non-Corporate Structure}

Tax considerations largely drive most RIC hedge funds and funds of hedge funds to organize themselves as limited partnerships or limited liability companies, rather than as a corporate or business trust entity common to mutual funds. This is due to the fact that, if organized as a corporation or business trust, in order to effectively avoid a double layer of federal income taxation, the RIC must satisfy a host of requirements as a “regulated investment company” under Subchapter M of the Internal Revenue Code.\textsuperscript{77} As a regulated investment company, a fund can distribute its net income and long-term capital gains to its investors without incurring an entity-level tax on those distributions, as it can deduct the distributions in calculating its taxable income.

A corporate RIC must derive at least 90\% of its gross income each taxable year from qualifying income, including dividends, interest payments with respect to securities loans, gains from the sale or other disposition of securities or foreign currencies, or other income derived with respect to its business of investing in securities or those currencies.\textsuperscript{78} There are also diversification requirements, including a quarterly asset test that requires that at least 50\% of the value of the RIC’s assets be represented by cash, cash items, U.S. government securities, and securities of other RICs or other securities (counting only those investments in other securities that do not exceed 5\% of the value of the RIC’s assets and not more than 10\% of any one issuer’s outstanding voting securities).\textsuperscript{79} In addition, a RIC cannot have more than 25\% of the value of its assets invested in the securities of any one issuer (other than governmental securities or interests in

\begin{footnotes}
\begin{enumerate}
\item[76.] Guide 4 to Form N-1A.
\item[77.] I.R.C. §§ 851–60G. A Subchapter M RIC offers a few advantages over a partnership RIC. The former blocks unrelated business taxable income (discussed in chapter 2), while the latter does not. In addition, the former will enable investors to receive tax information on Form 1099 rather than a Form K-1, which may make it simpler for investors from a tax reporting perspective.
\item[78.] I.R.C. § 851[b](2).
\item[79.] I.R.C. § 851[b](3).
\end{enumerate}
\end{footnotes}
other RICs) or any two or more issuers that the RIC controls and that are engaged in similar businesses. The RIC must also distribute to its shareholders an amount equal to 90% of its realized taxable income for the taxable year.\(^{80}\) It should also be noted that, in order to avoid the imposition of a 4% excise tax, a corporate RIC must distribute 98% of its calendar year ordinary income, 98% of excess capital gains over capital losses for the one-year period ending October 31 of the calendar year, and 100% of any undistributed income from the preceding year.\(^{81}\)

§ 5:2.5 Fund Governance and Administration

A RIC must satisfy the Investment Company Act’s governance requirements, which are far less flexible than those characteristic of an unregistered hedge fund. This currently requires that the fund effectively has a board of directors, at least 40% of whom must be persons who are not affiliated with or interested persons\(^ {82}\) of the fund or the fund’s investment adviser.\(^ {83}\) In addition, the investment advisory contract (or in the case of a limited partnership or limited liability company, the partnership or operating agreement) can continue for more than two years after execution only if its continuation is approved annually by the majority of the board of directors or by a majority vote of the fund’s investors, and the fund’s investors may terminate the contract at any time without penalty on sixty days’ written notice.\(^ {84}\)

RICs are also subject to a variety of SEC filing requirements and investor reporting obligations. Within sixty days after the end of the second fiscal quarter and fiscal year end, the fund must file with the SEC a report on Form N-SAR.\(^ {85}\) Within sixty days of the end of the other two fiscal quarters, a Form N-Q must be filed with the SEC, containing a schedule of the fund’s portfolio as of the end of those quarters.\(^ {86}\) In addition, the Investment Company Act requires the fund to transmit to its investors, at least semi-annually, reports containing financial statements (which, if as of the end of the fiscal year, must be accompanied by a certificate of an independent public accountant), a list showing the amounts and values of securities

\(^{80}\) I.R.C. § 852.

\(^{81}\) I.R.C. § 4982.


\(^{84}\) Investment Company Act § 15.

\(^{85}\) 15 U.S.C. § 80b-30(a), 30(b); 17 C.F.R. § 270.30a-1, .30b-1.

\(^{86}\) 17 C.F.R. § 270.30a-1.
owned as of the end of the semi-annual period, and certain other information required by the statute and its related rule. These reports are required to be mailed within sixty days after the end of the semi-annual period and four copies must be filed with the SEC within ten days after such mailing. Within ten days after sending its annual or semi-annual report to its investors, the RIC must file a Form N-CSR with the SEC in which the principal executive officer and financial officer of the RIC must certify certain financial information and the existence of certain internal controls, and pursuant to which various disclosures including those relating to the RIC’s code of ethics, proxy voting policies, portfolio managers and purchases of interests in the RIC by the RIC must be made.

The fund must also maintain accounts, books and other documents as the SEC may prescribe by rule. Rule 31a-1 serves as a form of checklist for such required books and records. These records must be maintained for the periods specified in Rule 31a-2. Rule 31a-3 relates to records prepared for the fund by third parties. The SEC is authorized by statute to inspect these books and records and conducts periodic inspections of the operations and records of RICs to monitor compliance.

§ 5:2.6 Investor Liquidity

Liquidity afforded investors in a RIC hedge fund or fund of hedge funds is limited where a partnership or limited liability company structure is used. This is required in order to avoid publicly traded partnership status. Moreover, section 23(c) of the Investment Company Act generally prohibits a RIC from purchasing any securities of which it is the issuer except in certain cases. Liquidity is typically provided pursuant to section 23(c)(2) of the Investment Company Act, which allows the RIC to make repurchases pursuant to tender offers, provided that reasonable opportunity to submit tenders is given to all holders of securities of the class of securities to be purchased. These tend to consist of a discretionary tender offer mechanism in which the RIC’s Board of Directors, upon advice from the RIC’s investment manager, elects to tender for interests in the RIC on an annual, semi-annual, or quarterly basis.

An alternative method of providing liquidity is to organize the RIC as an “interval fund.” These are closed end funds that make offers to purchase shares at periodic intervals of every three, six, or twelve months. Such repurchases must

87. 15 U.S.C. § 80-30[e]; 17 C.F.R. § 270.30a-1, .30b1-1, .30e-1.
88. See chapter 2, section 2:2.3[D].
89. 15 U.S.C. § 80a-23(c)(2); 17 C.F.R. § 270.23c-2.
90. 17 C.F.R. § 270.23c-2.
(1) provide notice at least twenty-one days and no more than forty-two days in advance,

(2) repurchase from 5% to 25% of the outstanding shares on the repurchase deadline, and

(3) determine net asset value no more than fourteen days after the repurchase deadline.

One must, however, be cognizant of the publicly traded partnership rules in structuring an interval fund, so as to avoid creating a secondary market for the shares of the RIC. 91

The fund must also not provide overly aggressive liquidity provisions as doing so may cause the RIC to be reclassified as an open-end fund. 92 In addition, the restrictive nature of the tender offer provisions must be clearly disclosed to investors. 93 Issuer repurchases through tender offers under section 23(c)(2) are also subject to the “tender offer” and “issuer repurchase” rules under sections 14 and 13(e) of the Exchange Act.

§ 5:2.7 Portfolio Management

A hedge fund organized as a RIC must contend with certain limitations on the manner in which it is managed. Section 17 of the Investment Company Act regulates and prohibits various affiliated transactions to address potential conflicts of interest. As such, there is less flexibility in terms of how a manager of a RIC interacts with the registered fund when compared to a manager’s dealings with an unregistered hedge fund. Section 17(a) prohibits certain transactions involving the purchase from or sale to the RIC of property by an affiliate, including its adviser acting as principal. Section 17(d), together with Rule 17d-1, restricts joint transactions involving a RIC and an affiliate or an affiliate of an affiliate. Section 17(e) restricts the amount of compensation an affiliate may receive when acting as an agent to the fund.

In terms of portfolio management, a RIC will be more constrained than an unregistered hedge fund. For one thing, RICs generally have

91. One must, however, be cognizant of the publicly traded partnership rules in structuring an interval fund. IRS regulations provide for a safe harbor that permits limited redemptions without creating PTP status. The redemptions must be made on sixty days’ notice, be made no more than four times per tax year, and the sum of all redemptions in a tax year may not exceed 10% of total capital. A second safe harbor permits unlimited redemptions if the RIC has only one opening for investors to invest in the RIC.

92. See Havatampa Corp., SEC No-Action Letter (July 20, 1977) (regular annual tenders did not cause a closed-end fund to be deemed an open-end fund).

less flexibility to change their investment objectives than do most hedge funds. Hedge funds often have broad investment mandates that enable them to dynamically adjust their focus, the instruments they trade, and the markets as conditions change. A RIC must set out in its registration statement its investment policies. It also prohibits any deviation from these policies and must obtain the consent of its investors before deviating from their fundamental policies.\textsuperscript{94} This however, can be addressed if the RIC’s investment policies are drafted so as not to be overly restrictive.

The Investment Company Act also restricts a RIC’s use of leverage. This restriction stems from the concept of “senior security.” A senior security is defined in section 18(g) of the Investment Company Act as “any bond, debenture, note, or similar obligation constituting a security and evidencing indebtedness, or in the case of any stock of a class having priority over any other class as to distribution of assets or payment of dividends.”\textsuperscript{95} In the case of a closed-end fund, its ability to issue debt is conditioned, in part, on its maintaining asset coverage of 300% immediately after the issuance of the debt. Preferred stock issuance requires coverage of 200%.\textsuperscript{96} Asset coverage in both instances are defined somewhat similarly in section 18(h) of the Investment Company Act. In the case of debt, the asset coverage of that class of debt senior security is defined as a ratio of $1$ the value of the total assets of the RIC, less all liabilities and indebtedness not represented by the class of debt senior security to $2$ the aggregate amount of the debt senior security.\textsuperscript{97}

While the statutory definition appears limited to debt and preferred stock issued by RICs, the SEC staff has interpreted senior security to encompass other arrangements and trading methods that may result in a leveraging of an RIC’s assets. This position was first articulated in a 1979 release in which the SEC stated that certain securities trading practices (reverse repurchase agreements, firm commitment agreements and standby commitment agreements) may involve borrowing that effectively leverages the RIC’s portfolio, magnifying the potential for gain or loss and increasing the speculative character of an investment in the RIC.\textsuperscript{98} In light of these findings, the SEC stated that these

\begin{itemize}
\item \textsuperscript{94} 15 U.S.C. § 80-8(b)(2).
\item \textsuperscript{95} 15 U.S.C. § 80-18(g).
\item \textsuperscript{96} 15 U.S.C. § 80-18(a).
\item \textsuperscript{97} 15 U.S.C. § 80-18(h).
\item \textsuperscript{98} Securities Trading Practices of Registered Investment Companies, General Statement of Policy, Investment Company Rel. No. 10,666 (Apr. 18, 1979). While the focus of the Release was on open-ended funds, the SEC stated that its analysis and recommendations were also addressed to closed-end funds. \textit{Id.} at n.1.
\end{itemize}
transactions effectively constituted the issuance by an RIC of a senior security, subjecting them to the prohibitions and asset coverage requirements of section 18. It went on to state that its analysis could be extended to other securities trading practices that may affect the leverage level of an RIC and has extended the senior security concept to other transactions involving potential leveraging, including short selling and the purchase and sale of futures contracts, options and currency forwards.

In addressing its concern about leverage, the SEC has stated that it will not view these transactions as senior securities if the RIC “covers” these transactions by either holding an offsetting long position in the financial instrument or by segregating on its books liquid securities in an amount sufficient to offset the position in question. For example, in the case of a fund with a long position in a futures or forward contract, or that sells a put option, senior security status can be avoided by establishing a segregated account containing cash or certain liquid assets equal to the purchase price of the contract or the strike price of the put option (less any margin on deposit). In the case of a short sale of a security, the fund may own an equal number of shares of that security or hold a call option on the same number of shares of the security with a strike price no higher than the price at which the security was sold short. While not precluding these various trading strategies, the requirement to segregate assets or hold offsetting positions imposes additional burdens on the RIC that are not required of an unregistered hedge fund.

100. Id.