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Marketing Non-US Private Equity Funds in the United States

A roadmap through the various regulations and tax implications can help ensure a successful offering.

Non-US private equity sponsors frequently seek to market their funds to US institutional investors. However, the evolving US regulatory regime necessitates careful planning to effect a successful US marketing effort. This *Client Alert* discusses a number of general legal considerations for offering a non-US private equity fund into the United States, with a particular focus on relevant aspects of US securities laws, commodity exchange laws, regulation of benefit plan investors and US federal income tax matters. Of course, beyond these general considerations, a particular private equity fund may have to contend with additional US laws and regulations, depending on the fund's targeted investors and investment strategy.

I. US Securities Laws

A. US Securities Act

The US Securities Act of 1933, as amended (the Securities Act), regulates the offer and sale of "securities", including investor interests in private equity funds. Under the Securities Act, offers and sales of securities must either be registered with the US Securities and Exchange Commission (the SEC) or exempt from registration. Registration of securities under the Securities Act requires, among other activities, preparation of an extensive registration statement and prospectus compliant with SEC rules, as well as compliance with the periodic and ongoing reporting regime under the US Securities Exchange Act of 1934, as amended (the Exchange Act). As a result, registration is not practical for most private equity funds. Instead, most private equity funds marketing in the United States typically rely on the private placement exemption contained in Section 4(a)(2) of the Securities Act and, in particular, the non-exclusive safe harbor exemption from registration provided by Rule 506(b) of Regulation D under the Securities Act, for securities offerings without general solicitation or general advertisement (a 506(b) offering).

While Rule 506(c) under Regulation D permits issuers to utilize general solicitation or general advertising in an exempt securities offering, issuers relying on Rule 506(c) are required to take more extensive steps to verify that purchasers of securities sold in any such offering are "accredited investors." For reasons beyond the scope of this *Client Alert*, the private equity industry generally does not rely on Rule 506(c).

A private offering under Rule 506(b) is subject to five main requirements:

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- **Offering Conduct.** Rule 506(b) offerings may not employ any "general solicitation or general advertising." While an analysis of offering conduct is necessarily fact intensive, in general, no public statement in any medium should refer to the offering, either specifically or to the fund sponsor's intended investment program more generally, or to other information that would be primarily of interest to prospective investors in the fund (*e.g.*, prior track record or performance information). In addition, web-based communications — such as either a public-facing website for the sponsor or a web portal to distribute fund documents — require careful scrutiny and the implementation of special protocols in connection with a 506(b) offering.

  As a means of avoiding general solicitation or general advertisement, 506(b) offerings are structured to focus on investors with whom the fund sponsor (or other persons acting on the sponsor's behalf, such as a placement agent) has a pre-existing, substantive relationship. Where an offering is so structured, Regulation D does not impose any strict limit on the number of offerees. A "pre-existing" relationship requires that a sufficient period of time separates the formation of the relationship from the subsequent offering of related securities.

- **Accredited Investors.** As a practical matter, offerings of private equity funds in the US are limited to persons the issuer reasonably believes are "accredited investors." [1] Accredited investors include, among others:

  - Any corporation, limited liability company, partnership, business trust or nonprofit organization, not formed for the specific purpose of acquiring Interests, with total assets in excess of US$5,000,000

  - Any natural person who had an individual income in excess of US$200,000 (or joint income with that person's spouse in excess of US$300,000) in each of the two most recent years, and a reasonable expectation of reaching the same income level in the current year

  - Any natural person with individual net worth, or joint net worth with that person's spouse, in excess of US$1 million excluding the value of the primary residence of such natural person (calculated by subtracting from the estimated fair market value of the property the amount of debt secured by the property — other than certain specified debts — up to the estimated fair market value of the property)

- **Limitations on Resale.** Securities placed in a 506(b) offering are restricted securities and cannot be resold without registration under the Securities Act or an exemption therefrom. Likewise, an issuer relying on 506(b) must use reasonable care to ascertain that a purchaser in the offering is not an "underwriter," which is, in general, a person who has purchased securities from an issuer with a view to, or who offers or sells for an issuer in connection with, the distribution of any security. Reasonable care may be demonstrated by (i) reasonable inquiry about whether a purchaser in the offering is acquiring the interests for itself or to sell to others, (ii) providing written disclosures that the securities have not been registered and cannot be resold unless they are registered or unless an exemption from registration is available and (iii) placing legends on the certificate or other document that evidences the security (for private equity funds, legends are typically placed on the fund agreement and related subscription agreement) referencing applicable restrictions on transfer.

- **"Bad Actors."** If the fund or a broad range of specified "covered persons" is the subject of a "disqualification event" arising on or after September 23, 2013, the fund will not be permitted to rely on the Rule 506(b) exemption. The covered persons of a fund include its "related issuers" (*e.g.*, parallel funds), its general partner, a range of officers, directors and other control persons, any

placement agent (and persons compensated for placement services), and any beneficial owner of 20% or more of an issuer's outstanding voting securities. The fund and its sponsor must use reasonable diligence to identify any disqualification events or confirm the absence thereof. Specific disclosures rules apply to disqualification events arising prior to September 23, 2013, but the fund will not necessarily be disqualified from engaging in a 506(b) offering as a result thereof.

- **Form D Filing.** All issuers relying on Rule 506 of Regulation D are required to file a "Form D" electronically with the SEC no later than 15 days after the issuer's first sale of securities. The Form D must be amended at any time certain material information contained therein changes and/or if the issuer's offering extends for more than one year following the initial filing. The Form D is a brief notice that includes the names and addresses of the company's promoters, executive officers and directors, as well as high-level details regarding the offering. Filed Form Ds are publicly available via the SEC's website. Counterpart filings are typically required under applicable US state "Blue Sky" laws, based on the location of investors.[2]

While compliance with Regulation D exempts the issuer from the registration requirements of the Securities Act, Regulation D does not exempt the issuer from either federal or state antifraud rules. In particular, Rule 10b-5 under the Exchange Act prohibits — in connection with the purchase or sale of any security — making affirmative misstatements or omitting to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading.[3]

B. US Investment Company Act

The US Investment Company Act of 1940, as amended (the Investment Company Act), regulates the activities of "investment companies." The Investment Company Act is not limited to vehicles organized in the United States. Registration as an investment company imposes substantive limitations and ongoing reporting requirements on registrants, which are typically incompatible with the operations of a private equity fund. As a result, non-US private equity funds typically need to avoid investment company status under the Investment Company Act. Private equity funds generally avoid investment company status through reliance upon Section 3(c)(7) or Section 3(c)(1) of the Investment Company Act described below. Other exclusions or exceptions may also be available depending on a private equity fund's specific investment program.

- **Section 3(c)(7).** The typical private equity fund relies on Section 3(c)(7). Section 3(c)(7) requires that a private equity fund's outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities are "qualified purchasers." Notably, Section 3(c)(7) does not limit the number of investors in the fund, so long as each investor is a qualified purchaser. For this purpose, qualified purchasers include, among others, natural persons who own not less than US$5 million in "investments" or entities that own and invest on a discretionary basis not less than US$25 million of investments.

- **Section 3(c)(1).** To rely on Section 3(c)(1), a private equity fund's outstanding securities (other than short-term paper) must at all times be beneficially owned by not more than 100 persons. Section 3(c)(1) is subject to complicated "look-through" rules for purposes of determining a private equity fund's beneficial ownership count, and as a result a private equity fund's beneficial owners for purposes of Section 3(c)(1) are often not the same as its number of direct investors. In practice, the 100-owner limitation limits the utility of Section 3(c)(1), particularly for larger funds.

Both Section 3(c)(7) and Section 3(c)(1) require that the private equity fund must not make or presently propose to make a public offering of its securities; a requirement which is typically met through

compliance with Rule 506(b). Pursuant to Rule 3c-5 under the Investment Company Act, specified "knowledgeable employees" of the sponsor are excluded from qualified purchaser requirement for purposes of Section 3(c)(7) and are excluded from the 100 beneficial owner count for purposes of Section 3(c)(1). Also, a private equity sponsor may raise a fund relying on Section 3(c)(1) and a parallel fund relying on Section 3(c)(7) concurrently, without needing to integrate (or combine) the two funds for purposes of satisfying the requirements of each. The requirements for both Section 3(c)(7) and Section 3(c)(1) need to be maintained for the life of the fund, so sponsors must take care to monitor transfers of fund interests.

A non-US private fund can limit the scope of the Section 3(c)(7) and Section 3(c)(1) requirements to only the US investors of the fund, as described below.

C. US Investment Advisers Act

The US Investment Advisers Act of 1940, as amended (the Advisers Act), generally regulates "investment advisers" that are based in the United States or who advise clients in the United States. Under the Advisers Act, an "investment adviser" is any person who, for compensation, engages in the business of advising others as to the value of securities or to the advisability of investing in, purchasing or selling securities. As a general matter, if a fund sponsor conducts fundraising activities in the United States and counts US persons among its investor base, the fund sponsor will be subject to Advisers Act jurisdiction and will be required either to register with the SEC as an investment adviser or to operate within an appropriate exemption from registration. Investment advisers registered under the Advisers Act are subject to substantive regulation and periodic inspection by SEC staff as well as other oversight. While many US and global sponsors are registered as investment advisers under the Advisers Act, the substantive requirements of the Advisers Act can be challenging for non-US sponsors.

The Advisers Act provides narrowly tailored exemptions from registration for various categories of investment advisers, including for certain (i) private fund advisers, (ii) venture capital fund advisers and (iii) foreign private advisers. Fund sponsors that do not manage assets from within the United States often find the "private fund adviser" exemption to provide the most flexibility. Under the private fund adviser exemption, a non-US investment adviser (*i.e.*, an investment adviser whose principal office and place of business is outside the United States)[4] will be exempt from Advisers Act registration if (a) the adviser has no client that is a US person other than one or more qualifying private funds (in general, any private fund that is not an investment company in reliance on Section 3(c)(7) or Section 3(c)(1), as described above) and (b) all assets managed by the investment adviser at a place of business in the United States[5] are solely attributable to private funds, the total value of which is less than US$150 million.

Unlike the "foreign private adviser" exemption (which effectively limits a sponsor to 15 US investors with no more than US$25 million in capital commitments from those investors), a non-US adviser can take advantage of the private fund adviser exemption without regard to the type or number of its fund investors, or its non-US clients. However, non-US investment advisers should bear the following considerations in mind in connection with the private fund adviser exemption:

- **Inadvertent US Place of Business.** While the maintenance of a place of business in the United States does not necessarily preclude reliance on the private fund adviser exemption, the place of business can change the adviser's assets under management which count towards the US$150 million threshold. The place of business determination is necessarily fact-intensive, and a sponsor seeking to rely on the private fund adviser exemption may wish to implement policies and procedures designed to avoid an inadvertent place of business in the United States.

- **Calculation of Assets Under Management.** Private fund advisers must calculate the amount of assets under management in the United States annually and must remain below the US$150 million threshold in order to continue to rely on the private fund adviser exemption. Notably, assets under management are calculated based on the fair market value of the private funds advised by the sponsor, and includes uncalled capital commitments. If an adviser exceeds the US$150 million threshold, the adviser will be required to register as an investment adviser within the following three months.

- **Client Limitations.** A "private fund adviser" may not manage any assets (other than private funds) from a US place of business. In particular, single-investor or "fund-of-one" vehicles require careful analysis to determine whether they constitute private funds for purposes of the "private fund adviser" exemption.

While a "private fund adviser" is not required to formally register with the SEC in the United States, the exemption requires certain ongoing filings and recordkeeping undertakings, including the following:

- **Annual Filings.** A private fund adviser must electronically file with the SEC public reports on Form ADV as an "exempt reporting adviser" (ERA). ERAs are required to identify the exemption they are relying upon and complete certain items on Form ADV. Form ADV calls for identification of details such as form of organization and control persons; other business activities of the adviser and its affiliates; disciplinary history (including each disciplinary event) and information on each private fund advised (including service providers and gross assets). Reports must be amended at least annually within 90 days of an adviser's fiscal year end, and more frequently for certain changes that render the previously reported information inaccurate.

- **Duties Under the Advisers Act Applicable to Unregistered Advisers.** Several provisions of the Advisers Act, including the insider trading provisions in Section 204A of the Advisers Act and the broadly interpreted anti-fraud provisions in Section 206 of the Advisers Act, are applicable to unregistered advisers, including ERAs. All advisers, whether registered or unregistered, are prohibited from engaging in any act, practice or course of business that is fraudulent, deceptive or manipulative, or from employing any device to defraud any client or prospective client. In addition, Section 206 also requires that an adviser obtain prior client consent before engaging in principal or agency cross transactions with its clients. In other words, the adviser may not, without client consent, knowingly sell or purchase a security to or from a client, either for the account of the adviser (as "principal") or where the adviser acts as broker for another person ("agency cross") in the transaction.

  Notably, ERAs are also subject to the SEC's political contribution rules which effectively restrict ERAs from making political contributions to state and local government candidates and officeholders if those officeholders have authority or influence over a state or local government entity to whom the investment adviser provides investment advisory services, or is seeking to provide such services. Many US state or municipal pension plans are governed by trustees or other leadership personnel that include state elected officials or their appointees. Campaign contributions by sponsor personnel to such officials can therefore result in the sponsor being disqualified from receiving management fees or carried interest in respect of the related pension plan, for two years from the date of contribution. In practice, most sponsors simply prohibit, or severely restrict, any campaign contributions by their personnel.

- **Potential SEC Inspection.** ERAs, although not subject to routine examinations as with registered investment advisers, may be subject to inspection if the SEC determines such inspections are necessary.

- **Potential Future Recordkeeping Requirements.** In the future, the SEC may promulgate further recordkeeping requirements for ERAs in order to confirm compliance.

D. Side-By-Side US and Non-US Offerings

Many sponsors offering funds into the United States effect a "global" offering pursuant to Regulation D and Section 3(c)(7)/Section 3(c)(1) of the Investment Company Act. In a global offering, the sponsor applies the restrictions of Regulation D and Section 3(c)(7)/Section 3(c)(1) to all investors in the offering, regardless of where the investor is located.

However, non-US sponsors may not be accustomed to applying these restrictions throughout their private fund offerings, and their non-US investors may find the related qualification requirements burdensome and irrelevant. These sponsors may choose to conduct a "dual track" placement via two separate offerings: one to US investors, concurrent with a separate offering to non-US investors. In brief, under a series of SEC no-action letters, a private investment fund formed in a non-US jurisdiction that maintains its principal place of business outside of the United States is generally not required to analyze the status of investors residing outside of the United States for purposes of the Investment Company Act, and only the US investors of such funds need to be taken into account for purposes of Section 3(c)(7) or Section 3(c)(1) of the Investment Company Act.

Moreover, fund sponsors may, in lieu of reliance on Regulation D, avail themselves of Regulation S in connection with placements of securities outside of the United States to non-US persons. While a full recounting of Regulation S is beyond the scope of this *Client Alert*, Regulation S offers an exemption from the registration requirements of the Securities Act because US jurisdictional means are not used in connection with the offering.[6]

A side-by-side US and non-US offering includes two distinct offerings, which need to remain distinct throughout the course of fundraising. For this reason, some fund sponsors conclude that applying the Regulation D general solicitation and general advertisement restrictions on a global basis is often prudent.

II. Commodity Exchange Act

Funds, investment trusts and other investment vehicles which enter into futures, options on futures and/or swaps (collectively Commodity Interests) are considered to be "commodity pools" under the Commodity Exchange Act, as amended (the CEA), and related regulations promulgated thereunder by the US Commodity Futures Trading Commission (the CFTC). CEA and CFTC regulations require operators of and advisors to commodity pools to register with the CFTC as commodity pool operators (CPOs) or commodity trading advisors (CTAs), respectively, absent an applicable exemption. CFTC regulations provide for several exemptions, including from CPO and/or CTA registration, as applicable, for private funds entering into a *de minimis* amount of Commodity Interest positions.

As a result, private funds with a US jurisdictional nexus that intend to invest in Commodity Interests in connection with their investment program — whether as "true" hedge funds focused on derivatives transactions, or as traditional private equity funds where derivatives are used solely to hedge portfolio investment risks — will need to register as a CPO and CTO, or locate a suitable exemption.

While additional exemptions may be available, we have described below the most common exemptions private funds rely upon.

A. Exemption for Commodity Pool Operators

CFTC Rule 4.13(a)(3), or the "private fund *de minimis* exemption," provides an exemption from CPO registration where the following conditions are met:

- Interests in the commodity pool are exempt from registration under the Securities Act and are not publicly marketed in the United States.
- The commodity pool engages in a limited amount of trading in Commodity Interests, based on either of the following tests:
  - **5% Test:** The aggregate initial margin, premiums and required minimum security deposit required to establish such Commodity Interest positions does not exceed 5% of the liquidation value of the commodity pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions.
  - **Alternative Net Notional Test:** The aggregate net notional value of the pool's Commodity Interest positions[7] (determined at the time the most recent position was established) does not exceed 100% of the liquidation value of the commodity pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions.[8]
- Participation in the pool is limited to certain types of qualified investors.[9]
- The pool is not marketed as or in a vehicle for trading in the Commodity Interest markets.

Fund operators relying upon the CPO registration exemption provided under CFTC Rule 4.13(a)(3) must (i) make certain disclosures to prospective participants regarding such exemption; (ii) file notice of such exemption with the National Futures Association (the NFA) with respect to each commodity pool for which it is claiming the exemption; and (iii) renew such exemptive filing on an annual basis.

B. Exemptions for Commodity Trading Advisors

CFTC Rule 4.14(a)(5)

CFTC Rule 4.14(a)(5) exempts a person from the requirement to register with the CFTC as a CTA if each of the following conditions is met:

- The person is exempt from registration as a CPO under the CEA.
- The person's Commodity Interest trading advice is directed solely to, and for the sole use of, the commodity pool(s) for which such person is exempt from registration as a CPO.

The CTA registration exemption provided under CFTC Rule 4.14(a)(5) is self-executing, meaning that persons relying upon such exemption need not file notice of such exemption with the NFA.

CFTC Rule 4.14(a)(8)

CFTC Rule 4.14(a)(8) exempts a person from the CTA registration requirement if, in general, each of the following conditions is met:

- The person is registered as an investment adviser under the Advisers Act or with the applicable securities regulatory agency of any State, or is otherwise exempt from such registration.

- The person's Commodity Interest trading advice is directed solely to, or for the sole use of either (i) a CPO that has claimed an exemption from registration under CFTC Rule 4.13(a)(3) or (ii) a registered CPO that may nonetheless treat each commodity pool it operates meeting the criteria of CFTC Rule 4.13(a)(3) as if it were not registered as a CPO.
- The person provides Commodity Interest trading advice solely incidental to the person's business of providing securities or other investment advice to qualifying entities, collective investment vehicles and commodity pools.
- The person is not otherwise holding itself out as a CTA.

Fund advisors relying upon the CTA registration exemption provided under CFTC Rule 4.14(a)(8) must (i) file notice of such exemption with the NFA with respect to each commodity pool for which it is claiming the exemption and (ii) renew such exemptive filing on an annual basis.

III. Pension Plan Investors in Private Equity Funds

The US Employee Retirement Income Security Act of 1974, as amended (ERISA), governs certain employee benefit plans, including the corporate pension plans that frequently seek to invest in private funds. Various provisions of ERISA and of the Internal Revenue Code of 1986, as amended (the Code), impose fiduciary obligations on those with authority or control over the assets of private employee benefit plans (collectively ERISA investors) and/or impose excise taxes or other penalties on certain transactions involving the assets of employee benefit plans. Private equity funds targeting US private pension plan investors therefore should be alert to ERISA considerations.

ERISA contains a “look-through” rule under which, if no exception applies, the assets of a private equity fund with ERISA investors — including a non-US fund with US pension plan investors — are deemed to be “plan assets” under ERISA regulations, such that:

- The general partner (or other manager) of the plan asset fund becomes subject to the far-reaching fiduciary responsibility rules of ERISA.
- Transactions of the plan asset fund are subject to the prohibited transaction rules of ERISA and the Code. As a general matter, transactions with affiliates and potentially many other third parties would be prohibited, apart from narrowly-crafted exemptions.
- The benefit plan trustees may be liable for the investment decisions of the general partner (or other manager) of the plan asset fund.

As a result, most private equity funds seek an exception from treating the assets of the fund as plan assets. Private equity funds employ two common exceptions to avoid holding plan assets:

- The aggregate participation of ERISA investors in the fund is less than 25% of each class of the fund’s equity securities (the 25% exception).
- The fund qualifies as a “venture capital operating company” (VCOC).

While the 25% exception can be relatively straightforward, complying with the VCOC exemption involves careful planning. In general, under applicable ERISA regulations, a private fund is a VCOC if both:

- The fund has direct contractual rights to substantially participate in or substantially influence the management of "operating companies"[10] comprising at least 50% of its assets (measured at cost). Importantly, joint ventures and other structures where a fund invests indirectly through intermediate entities co-owned with other persons may not be deemed investments in operating companies for this purpose.

- In the ordinary course of its business, the fund actively exercises such management rights with respect to at least one of the operating companies in which it invests each year.

The VCOC requirements must be satisfied on an ongoing basis. An entity will not qualify as a "venture capital operating company" unless it meets the 50% test at the time it makes its first long-term investment, and it will cease to be a VCOC if it fails to meet the 50% test on at least one day during an annual testing period thereafter. (Once it fails or ceases to qualify, an entity cannot later re-qualify.)

In sum, if a private equity fund elects to qualify as a VCOC, it will need to analyze the fund's ultimate investment structures, as well as substantive management rights with respect to its investments, on an ongoing basis throughout the life of the fund. Likewise, if a sponsor elects to rely on the 25 percent exception, it should be prepared to analyze ongoing transfers of fund interests. Also notably, certain ERISA investors may request certifications or opinions as to the fund's ERISA compliance.

IV. US Federal Income Tax Matters

While the overall structure of a private equity fund will vary depending on the types of investors targeted and investments expected, a private equity fund is typically formed and intended to be treated as a "partnership" for US federal income tax purposes. As such a partnership, the fund itself will not be subject to US federal income tax. If, however, a domestic fund were taxable as a "corporation" for US federal income tax purposes, it would be subject to US federal income tax on its earnings (or, in the case of a fund that is a non-US entity, the portion of its earnings that are effectively connected with a US trade or business) at US federal income tax rates that are applicable to corporations. As a result, income of the fund distributed to the partners would generally be subject to two layers of US federal income tax if it is treated as a corporation for US federal income tax purposes. No entity-level tax would generally apply if it is treated as a partnership for US federal income tax purposes. Many funds seeking to be treated as a partnership for US federal income tax purposes take active steps to avoid treatment as a corporation for US federal income tax purposes.

In addition, private equity funds treated as partnerships for US federal income tax purposes and admitting US partners will likely need to include provisions in their constitutive documents regarding compliance with partnership tax accounting provisions. These may include, for example, provisions dealing with the maintenance of US-style "capital accounts" and provisions that provide how income and loss is allocated for US income tax purposes. Close coordination with tax counsel and tax accountants are important in drafting those provisions, as well as their implementation throughout the life of a fund.

For non-US investors in private funds (both US and non-US funds), a central concern is often the US federal income tax and income tax return filing requirements with respect to any income that is effectively connected to a "trade or business" conducted within the US (ECI). If the fund (or any flow-through entities in which it invests) is treated as engaged in a trade or business within the US, then any non-US partners in the fund will generally be treated as engaged in such a trade or business and maintaining an office or other fixed place of business in the US as well, regardless of the extent of their ownership. To the extent a non-US fund makes portfolio investments in the US, it may trigger ECI considerations for its non-US investors. Such considerations are complex and beyond the scope of this *Client Alert.* [11]

For US investors in non-US funds, the core tax concerns will depend on the nature of the investors, as well as the nature of the private equity fund's investments, as described further below. In particular, we discuss special considerations for US tax-exempt investors investing in non-US private equity funds.

A. Special Concerns for US Tax Exempts

An entity that is otherwise exempt from US federal income tax (a US tax-exempt entity) may be subject to US federal income tax filing requirements and US federal income tax liability if it recognizes "unrelated business taxable income" as defined under the Code (UBTI). UBTI is generally defined as income from a trade or business regularly carried on by a US tax-exempt entity; trade or business that is unrelated to its exempt purpose (including an unrelated trade or business regularly carried on by an entity that is not taxable as a corporation for US federal income tax purposes (a flow-through entity) in which the US tax-exempt entity invests). UBTI can be generated outside of the United States, such that UBTI considerations remain relevant for non-US funds with US tax-exempt investors.

While UBTI generally does not include dividends, interest, rents from real property and gains from the sale of property that is neither inventory nor held for sale to customers in the ordinary course of business, it does include operating income from operating assets that are held in a flow-through entity. Moreover, if the fund incurs debt that is allocated to its acquisition of an investment (or if a flow-through entity in which the fund invests incurs debt that is allocated to an investment or asset held by the flow-through entity), all or a portion of the income or gain attributed to such debt-financed property may be treated as UBTI, regardless of whether it would otherwise be excluded under the general rules. Each private equity fund's ultimate UBTI profile will depend on its individual investment strategy, although certain types of energy, infrastructure and other natural resources funds may invest with some regularity in flow-through entities and may generate UBTI.

Some US tax-exempt entities can tolerate the incurrence of UBTI, while others prefer not to incur UBTI. As a result, private equity funds may incorporate covenants in respect of the avoidance of UBTI by partners who so elect. These covenants are usually operationalized through the use of "blocker corporation" structures administered by the fund sponsor, where an entity taxed as a corporation for US federal income tax purposes is interposed between electing tax-exempt partners and the fund. Interposing this type of entity does not eliminate the tax payment or tax filing obligation but instead places the burden of paying any applicable US taxes and filing any applicable US tax returns on the interposed entity. In determining whether to offer such structures, sponsors weigh the tax, legal, accounting and other burdens associated with maintaining and administering these structures over the life of their funds. If a blocker structure will be used, the fund offering documents should include clear disclosure regarding the effects of the blocker corporate structure.

B. Certain Considerations Regarding Non-US Investments for US Partners

Investments in non-US jurisdictions may also cause the fund and its partners to be subject to special US federal income tax, withholding, reporting and filing requirements, including the following:

CFCs and PFICs

If a US person actually or constructively owns at least 10% of the voting stock of a non-US corporation, such US person is considered a "United States Shareholder" with respect to such corporation. If United States Shareholders in the aggregate actually or constructively own more than 50% of the voting power or value of the stock of such non-US corporation, the entity will be classified as a "controlled foreign corporation" (a CFC) for US federal income tax purposes. If a fund invests in a CFC for 30 days or more during a taxable year, any United States Shareholders (such as the US partners in the fund where the fund is a domestic partnership), will generally be subject to US tax on certain income and earnings of the

CFC, even if the fund and its partners do not receive cash distributions from such CFC. In addition, any gain recognized on the sale of the CFC's stock (including any gain recognized indirectly as a result of the sale of a US partner's interest in the fund if the fund is a United States Shareholder or any gain recognized by a US partner if the fund is not a United States Shareholder but the US partner is a United States Shareholder) may be classified as dividend income taxable at ordinary income rates such that it would not be eligible for the preferential rates that may apply to income taxed as capital gains.

In addition, if a fund invests in a non-US corporation in which either (i) 75% or more of its gross income for a taxable year is passive income or (ii) 50% or more of its assets in a taxable year (by value) produce passive income or are held for the production of such income, such corporation will generally be characterized as a "passive foreign investment company" (a PFIC). If a fund were to invest in a PFIC, any gain on the disposition of the PFIC's stock (or recognized on the sale of a US partner's interest in the fund that is attributable to such PFIC stock), as well as certain earnings of the PFIC, would be taxed as ordinary income and may also be subject to an additional interest charge. While a fund (or, where the fund and any intermediaries are treated as non-US entities, the US partner) may make an election to avoid the incurrence of such an interest charge in certain circumstances, in this case the US partners in the fund would be required to take a portion of the PFIC's earnings and income into account on an annual basis, regardless of whether the PFIC makes any distributions to the fund and its partners.

In light of the tax consequences that may apply to the fund and to its US partners, should it invest in a CFC or a PFIC, the fund should consider what protections, if any, may be appropriate for its partners. In this regard, while the fund could avoid investing in CFCs and PFICs by not investing in non-US entities that are treated as corporations for US federal income tax purposes, investments in flow-through entities could increase the risk of the fund and its partners being required to recognize, among other categories of income, UBTI. Accordingly, the appropriate protections and structuring alternatives with respect to each should be considered both at the time of the fund's formation and of any non-US investments.

Non-US Filing Obligations and Non-US Withholding Taxes

If a fund makes investments in jurisdictions outside the United States, the fund or the investors in the fund may be subject to income or other tax in that non-US jurisdiction. Additionally, withholding taxes or other taxes may be imposed on income or gains of the fund from investments in such non-US jurisdictions. Investors often request that funds limit the ways in which they invest in non-US jurisdictions so that the investors are not themselves subject to non-US income or tax filing obligations. In addition, investors often want the fund (and not the investors) to bear any non-US income taxes and non-US withholding taxes as a fund expense and not treat such amounts as having been distributed to the investors in the fund. Whether this is practical will depend on the jurisdictions in which the fund plans to invest and the type of investments that the fund plans to make. Many non-US jurisdictions impose withholding taxes or non-resident capital gain taxes when disposing of certain types of investments and care must be taken to ensure that any limitations in the fund agreement do not inhibit the fund's ability to invest.

FATCA

Sections 1471 through 1474 of the Code and the guidance promulgated thereunder (commonly referred to as FATCA) impose a 30% withholding tax on certain "withholdable payments" made to "foreign financial institutions" (FFIs) and certain other non-US entities, unless certain requirements are met. Under current guidance, withholdable payments include, but are not limited to, US source dividends, interest and gross proceeds from the sale of any property of a type that can produce US source interest and dividends (generally equity or debt instruments of US issuers). Under applicable Treasury Regulations and administrative guidance, the 30% withholding tax currently applies only to US source interest, dividends and certain other "fixed or determinable, annual or periodic" payments and will apply to gross proceeds

from a sale or disposition of such US source investments made on or after January 1, 2019. The Code and Treasury Regulations broadly define FFI to include any non-US entity that is a financial institution, and further specify that investment entities, including private equity funds, will be treated as financial institutions. Accordingly, if the fund is treated as a non-US entity (or invests in non-US entities), then the fund (or such non-US entities) would be subject to a 30% withholding tax on any withholdable payments made to it, unless the fund enters into an agreement with the US Treasury Department (or is in compliance with a law imposed in a non-US jurisdiction to implement an intergovernmental agreement that generally requires) that the fund undertake to (i) identify accounts held by certain US persons and non-US entities owned by such persons, (ii) annually report certain information about such accounts, and (iii) withhold 30% on payments to account holders (including investors) whose actions prevent it from complying with these and other requirements.

If a fund is unable to comply with the information reporting requirements imposed under FATCA (or to provide the information required for a non-US entity in which it invests to so comply), including as a result of a non-US partner's failure to provide any required information, then any withholdable payments made to the fund by non-US entities in which it invests, and/or distributions made by the fund to certain non-US investors, may be subject to FATCA withholding. Accordingly, the fund sponsor should consider what protections are appropriate to ensure it is able to comply with FATCA, as well as to potentially pass the costs of any non-compliance to any investors whose failure to provide information may preclude the fund from so complying or otherwise subject it to FATCA withholding.

Conclusion

A successful fund offering into the United States necessarily begins in the planning stages prior to launch. In the first instance, the sponsor should develop its marketing plan in consultation with legal counsel and any outside marketers, such as placement agents. Non-US sponsors may also want to revisit their marketing materials in view of a potential US marketing effort. For example, marketing materials may need to include additional legal disclosures to address the fund's US marketing, and the sponsor may wish to understand how the business sections of its marketing materials (*e.g.*, description of investment strategy, market opportunity and any prior track record or performance information) compare to US private fund marketing norms. Lastly, a sponsor may wish to review its fund terms to better understand how US institutional investors will likely receive them.

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Endnotes

[1] As a technical matter, a 506(b) offering may include no more than 35 purchasers of securities that are not "accredited investors." Any investors in a 506(b) offering that are not accredited investors (and, potentially, other investors as well) must receive extensive disclosures from the issuer that are roughly the same as the disclosures required in offerings registered with the SEC. As a result, general market practice is to exclude non-accredited investors from participation in such funds.

[2] US state "Blue Sky" laws may also impose additional requirements on issuers, depending on the US state in which an investor resides.

[3] Rule 10b-5 may be enforced by civil or administrative actions by the SEC or by criminal actions by the Department of Justice. In addition, it has long been established that there is an implied private right of action under Rule 10b-5.

[4] The "principal office and place of business" is defined as the executive office of the investment adviser from which the officers, partners, or managers of the investment adviser direct, control and coordinate the activities of the investment adviser.

[5] "Place of business" is defined as any office where the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

[6] Depending on the nature of the offering, Regulation S may require the issuer to impose various offering and transfer restrictions.

[7] For purposes of CFTC Rule 4.13(a)(3), CFTC regulations provide a formula for calculating "notional value." *See* 17 C.F.R. § 4.13(a)(3)(ii)(B).

[8] All of a commodity pool's positions (or margin, premiums and required minimum security deposits posted with respect to such positions, as applicable) in commodity interests — including those associated with *bona fide* hedging — must be included in the calculations made under CFTC Rule 4.13(a)(3). *See* 17 C.F.R. § 4.13(a)(3)(ii).

[9] CFTC Rule 4.13(a)(3) requires that the person relying on the CPO exemption reasonably believe at the time of the investment that each person who participates in the commodity pool is (i) an "accredited investor" (as defined in Regulation D under the Securities Act), (ii) a trust that is not an accredited investor, but that was formed by an accredited investor for the benefit of a family member, (iii) a "knowledgeable employee" (as defined in Rule 3c-5 under the Investment Company Act) or (iv) a "qualified eligible person" (as defined in 17 C.F.R. § 4.7(a)(2)(viii)(A)). 17 C.F.R. § 4.13(a)(3)(iii).

[10] An "operating company" generally is an entity primarily engaged in the production or sale of a product or service, other than the investment of capital.

[11] Further, Section 897 of the Code provides that non-US persons (other than any "qualified foreign pension funds") will be taxed on gain from the sale of a US real property interest (USRPI), which includes shares of a corporation that is treated as a US real property holding corporation (USRPHC), in the same manner as they are on ECI, regardless of whether the taxpayer otherwise conducts a US trade or business. In addition to shares in a USRPHC, Section 897(c) of the Code generally defines USRPI as any interest in real property (other than solely as a creditor) located in the US or Virgin Islands, including certain interests in oil and gas reserves and also in certain personal property to the extent such property is associated with the use of such real property.

Foreign government investors may also be concerned with so-called "commercial activity income," a full discussion of which is beyond the scope of this *Client Alert*.