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Structuring Direct Lending Funds: Open-Ended vs. Private Equity/Closed-Ended Style Structures; Valuation; Tax and ERISA; Regulatory Considerations

WEDNESDAY, SEPTEMBER 27, 2017

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Alex Gelinas, Partner, **Sadis & Goldberg**, New York

Steven Huttler, Partner, **Sadis & Goldberg**, New York

Daniel G. Viola, Partner, **Sadis & Goldberg**, New York

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Structuring Direct Lending Funds

Open-Ended vs. Private Equity/Closed-Ended Style Structures; Valuation, Tax and ERISA; and Regulatory Considerations

September 27, 2017

SadisGoldberg LLP

Steven Huttler, Partner
Sadis & Goldberg LLP

Steven Huttler is a partner in the firm's Financial Services and Corporate Groups. Mr. Huttler has extensive experience in corporate, finance, investment fund and securities matters, including the representation of U.S. and foreign investment funds, underwriters, and private clients in various registered public and private offerings of debt and equity securities totaling in excess of $10 billion.

As part of his investment fund practice, Mr. Huttler has served as corporate counsel to many private investment funds and partnerships based in or domiciled in the United States and in international and offshore jurisdictions such as the Cayman Islands, Bermuda, the British Virgin Islands, Ireland, Luxembourg, Isle of Man, Jersey, Guernsey, Cyprus, Mauritius, United Kingdom, Austria, Russia, India and Gibraltar. Mr. Huttler's legal practice has exposed him to diverse fund clients with an exceptionally wide range of investment programs and structures, including large mutual funds and hedge fund complexes, private equity firms, real estate partnerships and funds, venture capital funds and funds focused on specialty finance assets. He has also counseled small start-up hedge funds and financial industry entrepreneurs. His practice has included structuring and establishing start-up funds and managed accounts, and structuring investment funds to benefit from U.S. double taxation treaties. He has advised management companies and fund managers on compensation structures, restructured and reorganized funds, structured, negotiated and documented fund trades, negotiated seed, joint venture and start up agreements, and advised on a range of sophisticated transactions. He has also represented financial services providers, such as brokerage firms (including proprietary trading broker-dealers), fund administration firms and third party marketing firms in structuring their operations, reorganizations to achieve tax benefits, advising on disputes with clients, and in the development of forms for their pension, investment, trading, administration and other services to investment funds, equity, debt and option traders and other clients.

SadisGoldberg LLP

Alex Gelinas, Partner
Sadis & Goldberg LLP

Alex Gelinas is a partner in the firm's Tax Group. Mr. Gelinas focuses his practice on providing tax advice to investment managers of hedge funds, private equity funds and other investment funds on all aspects of their businesses, including management entity and fund formation, partnership taxation issues, compensation arrangements and ongoing investment activities and transactions. Mr. Gelinas also provides tax advice to U.S. pension funds, sovereign wealth funds and other U.S. and foreign institutional investors in connection with their investments in private equity funds, hedge funds and U.S. joint ventures. He also has extensive experience in providing tax planning advice to high-net-worth individuals and families.

SadisGoldberg LLP

Daniel G. Viola, Partner
Sadis & Goldberg LLP

Daniel Viola is the Head of the Regulatory and Compliance Group. He structures and organizes broker-dealers, investment advisers, funds and regularly counsels investment professionals in connection with regulatory and corporate matters.

Mr. Viola served as a Senior Compliance Examiner for the Northeast Regional Office of the SEC, where he worked from 1992 through 1996. During his tenure at the SEC, Mr. Viola worked on several compliance inspection projects and enforcement actions involving examinations of registered investment advisers, ensuring compliance with federal and state securities laws. Mr. Viola's examination experience includes financial statement, performance advertising, and disclosure document reviews, as well as analysis of investment adviser and hedge fund issues arising under ERISA and blue-sky laws.

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Overview of Presentation

I. Current investment and lending climate – demand for nontraditional lenders

II. Structuring options for direct lending funds
   A. Standard LLC or partnership – when all investors are U.S. taxable investors
   B. “Season and sell”
   C. U.S. corporation blocker, owned by off-shore private fund, invests in U.S. loan origination fund
   D. Closed-end registered investment company

III. Key regulatory issues: valuation (from SEC perspective), conflicts of interest with affiliated service providers, principal transactions, calculation of AUM (*i.e.*, “Regulatory Assets Under Management”)

IV. Further structuring considerations: how to structure to accept investors that are primarily ERISA/IRA entities: Focus: conflicts of interest with affiliated service providers

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I. Current Investment and Lending Climate - Demand for Nontraditional Lenders

Current Investment and Lending Climate – Demand for Nontraditional Lenders

- Since 2008, the Perfect Storm:
  a. Cyclical markets
  b. Banks constrained by regulatory/capital requirements
  c. Investors needing real income
     i. Low interest rate environment
     ii. Individual retirees in particular need of income

- Popular Versions:
  - Real estate finance (sub-themes like commercial, MFH, vacation income properties, etc.)
  - Corporate lending
  - Entertainment finance
  - Health care finance

- Explosion of product

II. Structuring Options for Direct Lending Funds

Alternative Structures: Open Ended vs. Close Ended

1. Open end fund characteristics:
   - It looks like a mutual fund
   - Designed to last for an indeterminate time into the future
   - No specific term for it to close
   - Investors accepted and withdraw at specific, periodic times (monthly, quarterly, annually, etc.)
   - This requires a mechanism to value the portfolio whenever investors come join
   - Mechanism is also required to value the portfolio whenever investors withdraw

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Alternative Structures: Open Ended vs. Close Ended (cont.)

2. Closed end fund characteristics:
   - It is often referred to in the jargon of professionals and industry managers as "PE fund"
   - Designed to last only for pre-determine time into the future
   - Investors often make commitments rather than make immediate from investments
   - Specific periods identified in advance of the fund:
     - Closing period: period until which the fund may accept new commitments
     - Capital commitment call period: period until which the fund may call capital from investors who commit capital
     - Investment period: period until which the fund may make new investments
     - Investment "harvest" period: period until which the fund can hold the assets before they must be sold

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Alternative Structures: Open Ended vs. Close Ended (cont.)

2. Closed end fund characteristics (cont.):
   - Investors generally may not withdraw at any time
   - This means that NAVs will generally not be required for purposes of new and withdrawing investors
   - NAVs will generally required for GAAP and other reporting purposes, but not economic terms of the fund
   - Sometimes NAVs will required for certain other economic terms of the fund:
     - Limited adjustments to new investor investments (based on NAVs)
     - Limited withdrawals
     - Capital write-offs (for waterfalls)
     - Calculations of management fees

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Alternative Structures: Open Ended vs. Close Ended (cont.)

3. Comparison of Such Structures:
   - From most legal and operational perspectives, the closed end structure is preferable
   - Key advantages of closed end: fund economic terms not determined by NAVs
     - SEC doesn't like these funds
     - Regulator and investor concerns about such structures: unreliability of NAVs
     - Fraud and other malfeasance have dogged these assets in these structure
       - Performance and management fees set to AUM in open ended fund
       - Conflicts have proved irresistible many times, historically (*e.g.*, when fund is having problems)
     - **Some auditing firms will not audit an open end fund with illiquid assets**
       - Others set expansive requirements for valuation agents and methodologies
       - It will likely be **expensive** to deal with valuation
   - Operational advantages:
     - NAVs are just hard to strike
       - Under GAAP is not always crystal clear
       - Legal risks make auditors and others fearful and more demanding of the process
     - Selling assets for withdrawals:
       - Illiquid assets are hard to sell

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Alternative Structures: Open Ended vs. Close Ended (cont.)

3. <u>Comparison of Such Structures</u> (cont.)
    - Haircuts can be severe
    - Key advantage open end fund advantage is **<u>typically only one</u>**:
        - **Liquidity at times is an absolutely essential term to interest the investor pool in the fund**
            - Particularly for retail and family office investors, the need for some liquidity can be absolutely critical to signing up an investors
            - **Beware of illusion of liquidity**
            - **Particularly important for those of you reviewing a fund for an investor** (*e.g.*, quarterly liquidity except for the fine print)

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Alternative Structures: Open Ended vs. Close Ended (cont.)

4. Adaptions to Open End Structure: Hybrid Structure:
   - When: if marketing advantages of open ended structures are irresistible
   - Adaptation: Timing of Liquidity
     - Long initial lockups
       - 2-3 years (co-terminus with maturity of many products)
       - Exaggerated examples: life settlement fund we are working on now with 10 year initial lockup
     - Problem with long initial lockups:
       - Simply puts off the day of reckoning
       - How does one satisfy a wave of withdrawals a few years from now?
     - Other classic tactics:
       - Gates
       - Side pockets
     - However: marketing challenge
       - Side pockets in particular are very unpopular

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Alternative Structures: Open Ended vs. Close Ended (cont.)

4. Adaptions to Open End Structure: Hybrid Structure (cont.):
    - More complicated barriers to withdrawal:
        - Instead of only initial lockup, also impose "rolling lockup"
        - *e.g.*, only withdraw every 2-3 years
        - Different flavors: sometimes anniversary of particular investment by investors
        - Sometimes a single withdrawal opportunity for everyone every 2-3 years
- Adaptation: Funding of Liquidity
    - Payment of withdrawal subject entirely to availability of capital to pay it off
    - Payment of withdrawal subject entirely to subsequent sale of portfolio investments and having relevant proceeds available from it
    - Note the **"Illusory Liquidity"**

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Other Structural Issues and Alternatives: Tax-Driven Structures

1. <u>Extrinsic Issues Most Commonly Affect Structure</u>:
   - Greatest driver in structuring lending funds: **<u>tax issues</u>**
   - What are these tax issues?
   - Remember **the 3 different categories of investors** in most investment funds:
     - U.S. taxpayers
     - U.S. parties who are generally not subject to income tax in the U.S. (*e.g.*, pensions, charities etc.)
     - Non-U.S. investors
     - **Tax issues are different for these different categories**
   - Critical assumptions:
     - **U.S. borrowers and U.S. based collateral**
     - Most popular and successful strategies are like this, and this presentation addresses this - much more to say otherwise

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Other Structural Issues and Alternatives: Tax-Driven Structures (cont.)

2. What Are General Tax Concerns:
   - U.S. parties who are generally not subject to income tax in the U.S. (*e.g*., pensions, charities etc.):
   - What are these tax issues?
   - U.S. non-taxpayers (*e.g*., pensions, charities etc.)
     - "Unrelated Business Taxable Income" ("UBTI")
     - Fundamentally**: activities of a non-profit which are taxed under our tax regime**
     - Active business activities of the non-profit
     - Presumption that activities financed by leverage are active for this purpose
   - Non-U.S. non-taxpayers
     - "Trade or Business Activities in the U.S."
     - Fundamentally**: offshore investors in public markets don't pay tax on most of their income**
     - **We must be vigilant of business activities of an offshore investors which are taxed (heavily) under our tax regime**
     - Withholding

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Other Structural Issues and Alternatives: Tax-Driven Structures (cont.)

3. Goals for Tax-Driven Structures:
   - For U.S. non-taxpayers (*e.g.*, pensions, charities etc.):
     - Eliminate or ameliorate UBTI through structure
     - Eliminate by making income not "active"
     - Block it through tax structure through structure
   - For non-taxpayers
     - Eliminate or ameliorate "Trade or Business Activities in the U.S."
     - Eliminate by making income not "active" through structure
     - Block it through structure
     - Eliminate or ameliorate withholding through structure

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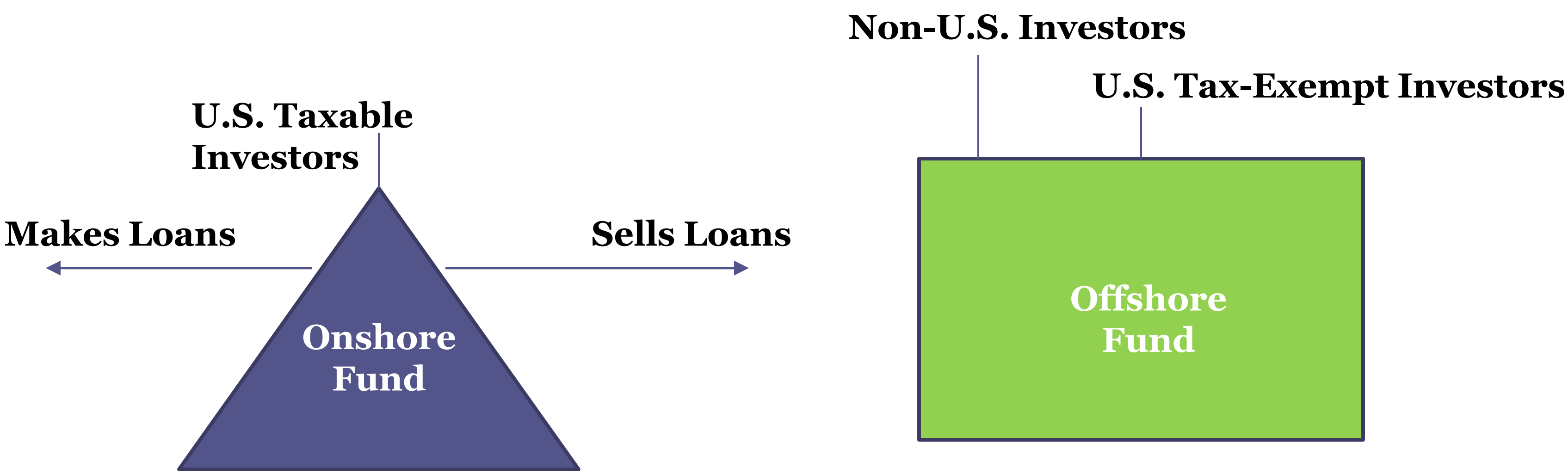
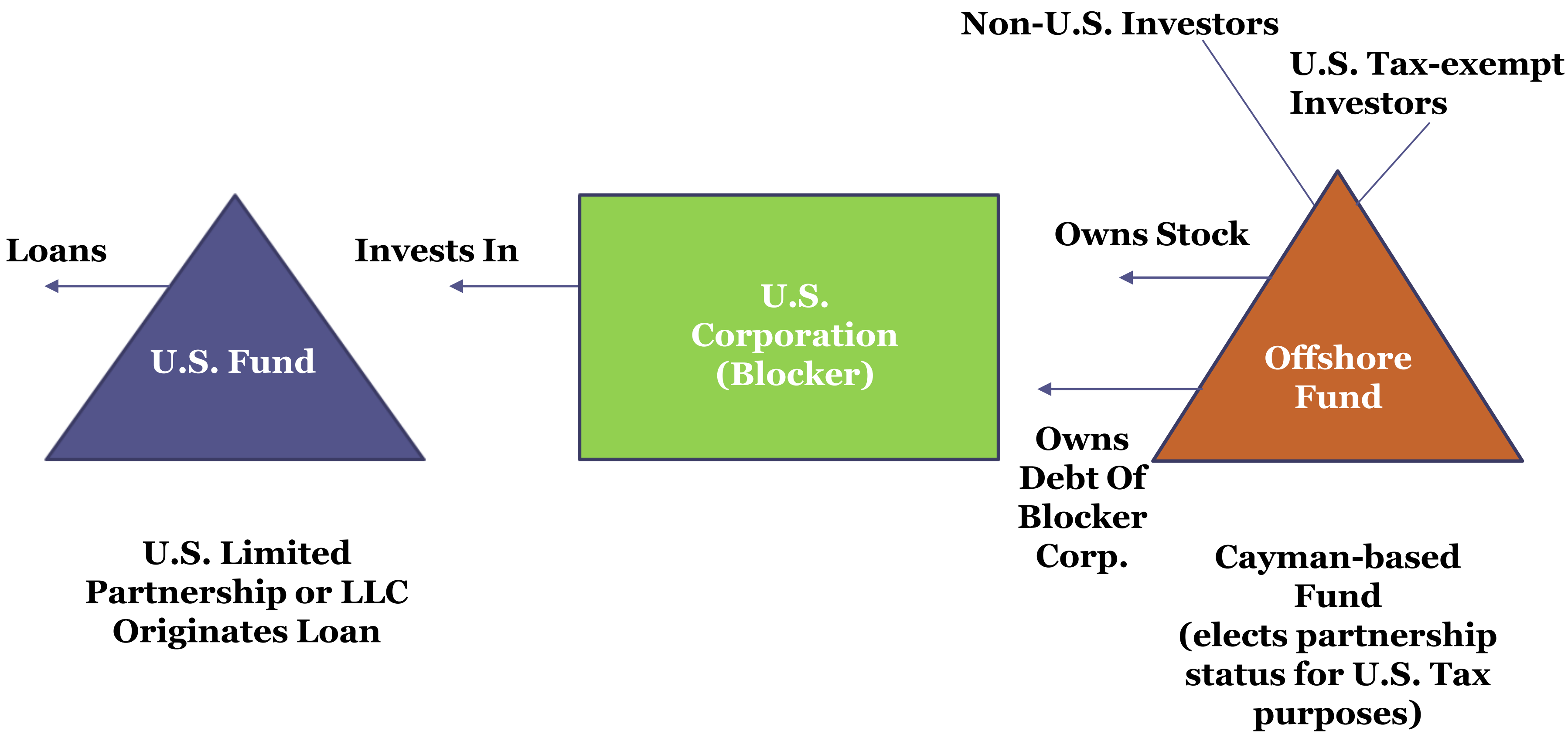
“Season and Sell” Strategy



Limited Partnership or LLC

Cayman Entity Elects to be Treated as a Foreign Corporation

U.S. Corporation Leveraged Blocker Structure



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Closed-end Registered Investment Company Structure

Loans

U.S. Corporation (RIC)

Elects RIC Status

Pays Interest-Related Dividends
(No U.S. withholding tax)

Shareholders are:
- **U.S. Persons**
- **Non-U.S. Persons**
- **U.S. Tax-exempt Entities**

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Tax Considerations for U.S. Taxable Investors

U.S. citizens and residents and other U.S. taxable investors have historically preferred to invest in funds that are treated as **partnerships for U.S. tax purposes** (typically formed as limited partnerships or limited liability companies).

A key benefit is that partnerships avoid entity level income taxes. Instead, all income, deductions and losses are passed through each taxable year to the partners. In addition, the character of the partnership's income, gain, loss, deduction and credits passes through to the partners.

Direct lending partnerships have some unfavorable tax characteristics:

Ordinary Income: Direct lending activities typically generate interest income that is ordinary in nature. In addition, any gains realized on sales of the loans by a lending business would generally be treated as gains from non-capital assets, which would result in ordinary income rather than long-term capital gain.

Phantom Income: Loans that are issued with original issue discount (**OID**) generate "phantom income" (*i.e.*, non-cash accrued income) notwithstanding that the interest is not actually received, even for cash method investors.

Tax Considerations for U.S. Taxable Investors
(cont.)

State and Local Tax Issues. State and local tax laws typically exempt out-of-state limited partners from taxation on investment fund activity in the state or locality that constitutes investing in stocks and securities. **Funds that are engaged in loan origination are often ineligible for this exemption.**

For example, **New York City has an unincorporated business tax** applicable to partnerships that are engaged in a trade or business in New York City. Funds are exempt from the NYC tax if they are just investing and trading in stocks or securities (including debt instruments), but would be subject to this tax if the fund is engaged in a loan origination business.

Publicly Traded Partnership Issues. Funds that have frequent admissions of investors and that allow frequent redemptions run a risk of being classified as publicly traded partnership (PTP). Unless an exemption applies, PTPs are subject to entity level income taxation as a corporation. There is a safe harbor rule that exempts a PTP from taxation as a corporation if at least 90 percent of its gross income is "**qualifying income**". **Income from a loan origination business would not be treated as qualifying income** under this PTP safe harbor.

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Tax Considerations for U.S. Taxable Investors

(cont.)

Passive Activity Loss Issues. Under the passive activity loss rules, which apply to non-corporate taxpayers, personal service corporations and certain closely held corporations, a limited partner's share of losses incurred in a loan origination business would be able to offset only income from another passive activity (and not salary, other active business income or the partner's portfolio income). **Income from an "equity-financed lending activity" may be classified as non-passive income,** which would mean that it could not be offset by passive activity losses of the partner.

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U.S. Tax Considerations for U.S. Tax-Exempt Investors

To the extent an investment strategy is likely to generate **unrelated business taxable income** for the U.S. tax-exempt investor, the tax-exempt investor would typically prefer to invest in an offshore fund treated as a foreign corporation to prevent its realizing UBTI.

UBTI is generally the excess of gross income from an unrelated trade or business conducted by the tax-exempt entity, or by a partnership in which it is a partner, over the deductions attributable to such business. In addition, **UBTI also includes "unrelated debt-financed income",** including debt-financed income of partnerships in which the tax-exempt entity invests.

Although loan origination could be treated as a business, the Code provides that **certain types of income, including interest, are specifically excluded from UBTI, regardless of whether such income items are derived in conducting a business, except to the extent such income items are considered "debt-financed income".** In addition to interest income, certain loan commitment fees and origination fees are also excluded from UBTI (if not debt-financed).

If the loan origination fund is a pass-through entity, the key tax issue for a prospective U.S. tax-exempt investor is whether the fund intends to use borrowed money in making its investments.

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U.S. Tax Considerations for Non-U.S. Investors

Non-U.S. investors generally prefer to invest in U.S. partnership funds through a non-U.S. corporation (*i.e.*, a "foreign blocker"). A foreign corporation will not be subject to the U.S. corporate income tax if it is not engaged (directly or as a partner in a partnership) in a trade or business within the United States. However, the non-U.S. investor's share of any income that is effectively connected with a U.S. trade or business ("ECI") is subject to the U.S. federal income tax.

U.S. Withholding Tax. Non-U.S. persons are also subject to U.S. withholding tax on certain types of U.S.-source income, including dividends and certain types of interest, that are not effectively connected with a U.S. trade or business of the non-U.S. person. **The Code contains an exemption from the U.S. withholding tax for "portfolio interest", provided certain conditions are satisfied.** U.S. tax treaties also provide a U.S. withholding tax exemption for interest income from sources in the United States, provided that such interest is not ECI.

Trading Safe Harbor. Code section 864(b)(2)(A)(ii) provides that, for a taxpayer that is not a dealer in such property, the term U.S. trade or business does not include investing in and trading in stocks and securities (including debt instruments) for the investor's account (the "**Trading Safe Harbor**"). **As discussed below, loan origination would generally not be eligible for exemption from U.S. taxation under this Trading Safe Harbor.**

U.S. Tax Considerations for Non-U.S. Investors (cont.)

U.S. Estate Tax Issues for Non-U.S. individuals. Non-U.S. individuals are subject to U.S. federal estate taxation at death on certain types of property that is considered "situated in the United States" **("U.S.-situs property").** There is only a small standard deduction available to estates of non-U.S. persons. U.S. estate tax treaties provide more generous relief for decedents that are domiciled in certain countries.

Definition of U.S.-Situs Property. U.S.-situs property includes equity interests in U.S. securities (including stock in U.S. corporations and debt instruments of U.S. obligors), equity interests in U.S. partnerships, and interests in U.S. real property, but **does not include stock in a foreign corporation (such as a "blocker corporation"), even if such foreign corporation owns U.S.-situs property.** For this reason, non-U.S. individuals will often hold U.S. assets in a foreign corporation (typically organized in a "zero-tax" jurisdiction, such as Cayman or the British Virgin Islands) to avoid possible federal and state estate taxation.

Under What Circumstances is Lending Treated as a U.S. Trade or Business?

As noted earlier, investing in and/or trading debt instruments of U.S. obligors can be exempt from U.S. federal income taxation under the Trading Safe Harbor. The courts and the IRS have held that the volume of money invested and the frequency of the trading activity are irrelevant to the applicability of the Safe Harbor. However, **the Safe Harbor is not applicable to direct lending activities which are carried out as a business in the United States**.

Is the Activity Continuous, Regular and Considerable?

The Code does not contain a clear test for what type of activity is treated as a U.S. trade or business. The courts that have considered the question have focused on whether the activity in question is "continuous, regular and considerable". As a result **this is a "facts and circumstances test".**

Under What Circumstances is Lending Treated as a U.S. Trade or Business? (cont.)

2009 IRS Chief Counsel's Memorandum

In 2009, the IRS released a Chief Counsel Advice memorandum on loan origination activities of a foreign corporation which concluded, under the facts described in such memorandum, that such corporation was in fact engaging in a U.S. trade or business. This memorandum, which was prepared in connection with an IRS audit of an offshore fund, caused considerable concern among lawyers and accountants who were advising hedge funds and other private investment funds that had crept into the direct lending sphere in the United States after the 2008 financial crisis.

Under What Circumstances is Lending Treated as a U.S. Trade or Business? (cont.)

Law Firms and Accountants Opinions on the ECI Issue Currently Vary

Among law and accounting firms, opinions diverge as to the number of lending transactions that an offshore fund may originate in a year before the fund is more likely to be treated as engaged in a U.S. trade or business. **Some firms are known to take the view that five or fewer transactions in a year are likely to be treated as safe to avoid ECI, while other firms are known to set the limit at three or two loans.**

There is one very old reported case, involving a non-U.S. person who was travelling in the U.S. and made one loan (and conducted limited other U.S. activities). The Tax Court concluded that one isolated financing activity was not sufficient to establish a U.S. trade or business. **Pasquel v. Commissioner, 12 TCM (CCH) 1431 (1953).**

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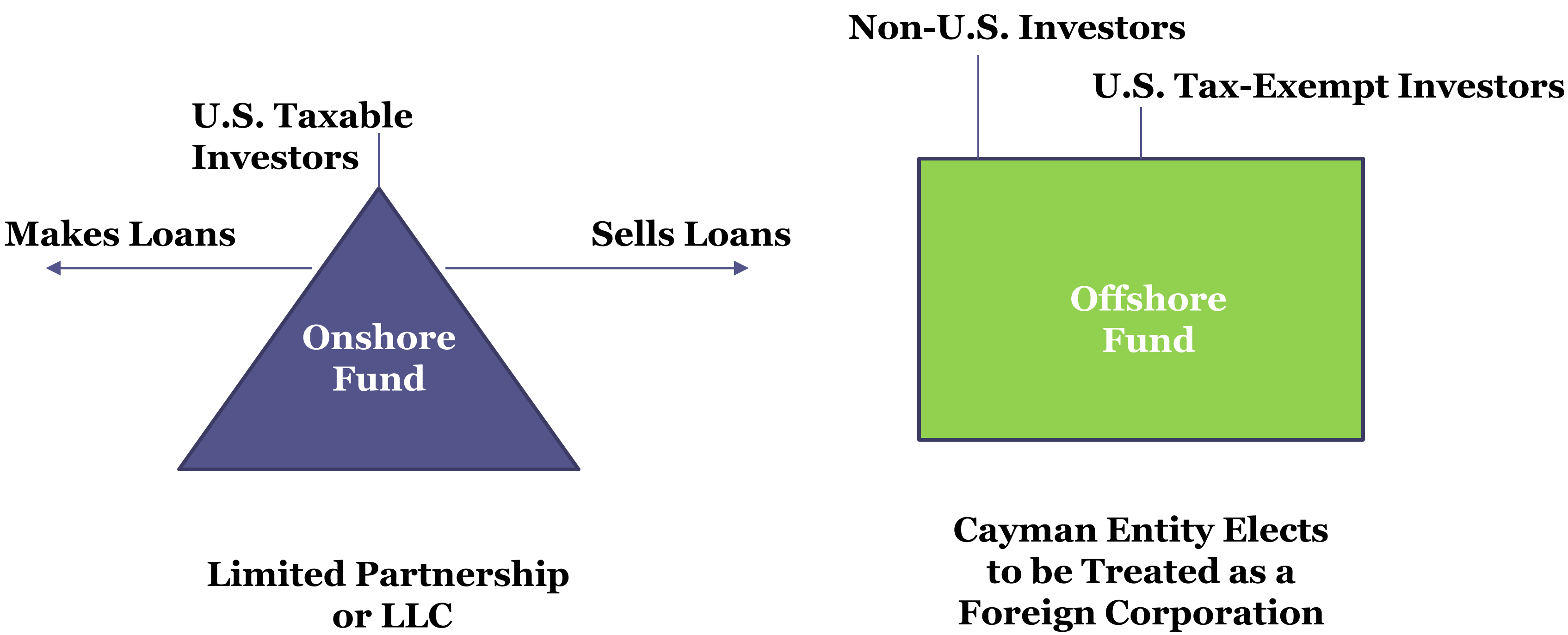
Loan Origination Versus Secondary Market Transactions

As previously discussed, purchasing loans, or participations therein, in the secondary market, after someone else has made the original loan, is treated as investment activity which is covered by the Trading Safe Harbor.

Distinguishing loan origination from secondary market activity is sometimes difficult. If the loan originator is an affiliate of the fund or other party purchasing the loan, the IRS could contend that the loan originator was active as an agent for the buyer of the loan.

"Season and Sell" Strategy



“Season and Sell” Strategy (cont.)

Many funds have used what is known as the “season and sell” strategy in order to avoid a foreign fund being classified as engaged in a U.S. trade or business.

A simple example of such a strategy is as follows: Two parallel funds are formed. One is a U.S. stand-alone partnership and the second is an offshore fund created in the Cayman Islands (or another no- tax jurisdiction) which is treated as a foreign corporation for U.S. tax purposes. **The onshore fund originates the loan, holds the loan for a period of time (known as the “seasoning period”) and then may offer to sell a portion of the loan to the offshore fund in a secondary market transaction for a price equal to the estimated fair market value of the portion sold.**

Independent Appraiser Needed. The fair market value issue is an important point. Funds are advised to engage an independent valuation agent to value some or all of the loans at the time of the sales of such loans to the offshore fund. Note also that in order for this structure to be feasible, **the onshore fund must have sufficient capital available to originate the loans.**

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"Season and Sell" Strategy (cont.)

Conflicts of Interest and Other Business Issues. Note that the investors in the two funds will not have identical returns on their investment, since the price paid by the offshore fund may be different that the value of the loan at the time the onshore fund originated the loan. If the same manager entity is acting on behalf of both the seller and the buyer fund, there would be **conflict of interest issues**, particularly if the manager's compensation structure is different for each fund.

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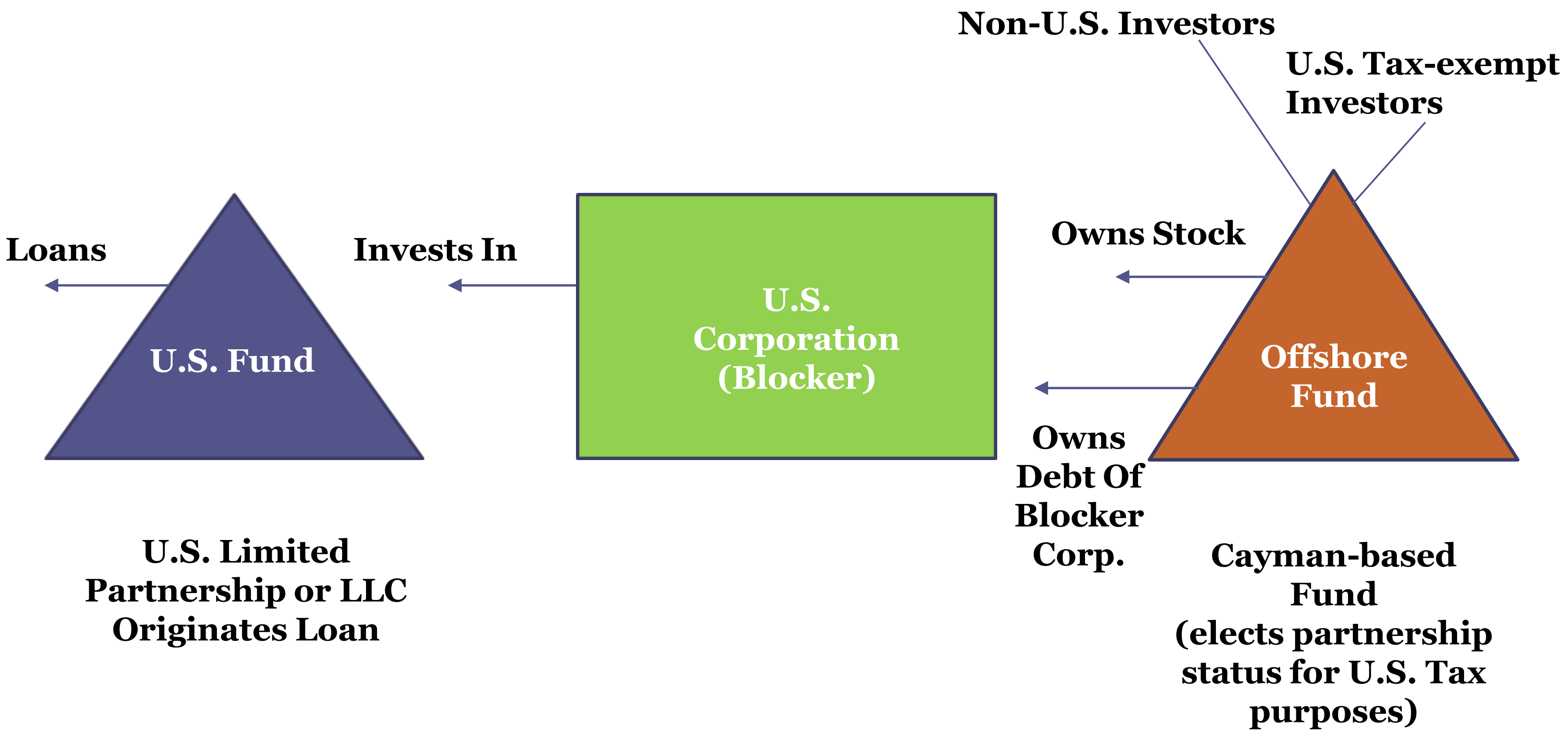
U.S. Corporation Leveraged Blocker Structure



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U.S. Corporation Leveraged Blocker Structure (cont.)

In this alternative structure, the non-U.S. and U.S. tax-exempt entities would invest in an offshore fund (typically organized in Cayman or another suitable offshore location). The offshore fund would form a U.S. corporation ("**U.S. Blocker**") which would engage in the direct lending activity in the U.S., or would acquire a limited partnership in the onshore partnership which would engage in the direct lending activity. **The offshore fund owns the stock of the U.S. Blocker but most of its investment is made to purchase debt of the U.S. Blocker.**

The U.S. Blocker would be subject to **U.S. corporate income tax on its net income. However, the strategy would be to reduce the U.S. Blocker's net taxable income by paying deductible interest to the offshore fund on its debt.** The strategy contemplates that such U.S.-source interest would be exempt from U.S. withholding tax either as portfolio interest or pursuant to applicable U.S. tax treaties with countries in which the investors in the offshore fund reside.

U.S. Corporation Leveraged Blocker Structure (cont.)

In order for the portfolio interest exemption to be available, the offshore fund would be required to elect to be treated as a pass through entity (*i.e.*, a partnership) for U.S. tax purposes. The portfolio interest exemption is only available if the recipient of the interest is deemed to own less than 10 percent of the voting stock of the U.S. Blocker. Similarly, the treaty-based exemptions from the U.S. withholding tax would only be available if the offshore fund is a pass-through entity for U.S. tax purposes.

U.S. Corporation Leveraged Blocker Structure (cont.)

Tax Issues and Risks – Debt vs Equity Issues

If the debt to equity ratio of the blocker corporation is "too high", or the terms of the debt held by the shareholders do not appear to resemble the terms that an unrelated lender would require, the IRS may disallow all or a portion of the blocker corporation's interest deductions, thereby increasing the blocker corporation's net taxable income.

Further, the IRS could contend that the disallowed "interest" paid to the blocker corporation's shareholders is actually a "U.S.-source dividend" which is not eligible for the portfolio interest exemption, and is instead subject to the 30 percent U.S. withholding tax (or lower rate under an applicable tax treaty).

In general, **the debt issued to the shareholders must have a stated maturity date, have a reasonable rate of interest (reflecting arm's-length terms) and should not be subordinated** to other indebtedness of the corporation.

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U.S. Corporation Leveraged Blocker Structure (cont.)

Tax Issues and Risks – Debt vs Equity Issues

There are **“anti-earnings stripping rules” in Section 163(j) of the Code** which can cap the amount of interest the blocker corporation can deduct for payments made to its shareholders and other related parties, if such interest payments are exempt from U.S. income tax **(“disqualified interest”)**. **This disallowance rule does not apply if the debt-to-equity ratio of the corporation does not exceed 1.5 to one, and the disallowance rule may be inapplicable for other reasons.**

<u>**Key Point**</u>**:** Section 163(j) only applies to the corporation’s “**excess interest expense**”, which is defined to include **the corporation’s interest expense that is <u>in excess of</u> its interest income.**

The blocker corporation’s interest expense deduction may be insufficient to offset all of the blocker corporation’s net income which is subject to U.S. corporate income tax. This would be likely if a portion of the corporation’s income is not interest (*e.g.*, fee income or gain on sale of loans or other property).

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Closed-end Registered Investment Company Structure

Loans

U.S. Corporation (RIC)

Elects RIC Status

Pays Interest-Related Dividends
(No U.S. withholding tax)

Shareholders are:
- **U.S. Persons**
- **Non-U.S. Persons**
- **U.S. Tax-exempt Entities**

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Closed-end Registered Investment Company Structure (cont.)

Another possible alternative would be to organize the fund as a closed-end registered investment company ("RIC") which is taxed under Subchapter M of the Code (*i.e.*, as a mutual fund). The RIC is a U.S. corporation, but it is allowed to deduct its dividends paid to reduce its taxable net income to zero. **The RIC structure acts as a blocker, and does not generate ECI for non-U.S. shareholders of the RIC or UBTI for U.S. tax-exempt shareholders of the RIC.** The structure also generates interest-related dividends (sourced from the debt holdings of the RIC) which would be exempt from U.S. withholding tax (as portfolio interest).

RIC structures require registration with the Securities and Exchange Commission and compliance with the regulatory requirements of the Investment Company Act of 1940. The Code also imposes investment diversification requirements and other requirements in order to retain RIC tax status.

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III. Key Regulatory Issues

Overview of Key Regulatory Issues for Private Lending Funds

1. Investment Fund: How many investors can participate

2. Investment Adviser Registration: Do unique assets make a difference in registration requirements

3. Special Conflict Issues: SEC Enforcement Issues

Key Regulatory Issues for Private Lending Funds

General Exemptions for Private Funds

- Investment Company Act 3(c)(1) and 3(c)(7)
- Investment Company Act 3(c)(5) for certain Private Lending Fund strategies:
  - Real estate and RE finance
  - Factoring
  - Insurance related finance
- SEC Rule 203(m)-1 under the Investment Advisers Act of 1940 ("The Act") permits an adviser to treat as a private fund for purposed of the exemption a fund that qualifies for an exclusion from the definition of investment company as defined in section 3 of the Investment Company Act in addition to the exclusions provided by section 3(c)(1), 3(c)(7) or 3(c)(5)
- 1999 accredited investors instead of 100?
- What percentage of portfolio needs to be devoted to exempt asset class to obtain benefit of 3(c)(5)?

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Key Regulatory Issues for Private Lending Funds

Investment Adviser Registration

- Do unique assets make a difference in registration requirements
- Are private loans "securities"?
- State as well as federal securities law considerations
  - Specific experience with state regulators
- How to count AUM (RAUM)

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Calculation of Regulatory Assets Under Management (“RAUM”)

Value of Regulatory Assets Under Management. Determine your regulatory assets under management based on the current market value of the assets as determined within 90 days prior to the date of filing the Form ADV. Determine market value using the same method used to report account values to clients or to calculate fees for investment advisory services.

In the case of a private fund, determine the current market value (or fair value) of the private fund’s assets and the contractual amount of any uncalled commitment pursuant to which a person is obligated to acquire an interest in, or make a capital contribution to, the private fund.

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Calculation of Regulatory Assets Under Management ("RAUM")

Example. This is an example of the method of determining whether an account of a client other than a private fund may be included as regulatory assets under management.

The client's portfolio consists of the following:

$ 6,000,000 stocks and bonds
$ 1,000,000 cash and cash equivalents
$ 3,000,000 non-securities (collectibles, commodities, real estate, etc.)
$10,000,000 Total Assets

First, is the account a securities portfolio? The account is a securities portfolio because securities as well as cash and cash equivalents ($6,000,000 + $1,000,000 = $7,000,000) comprise at least 50 percent of the value of the account (here, 70 percent). (See Instruction 5.b(1)).

Second, does the account receive continuous and regular supervisory or management services? The entire account is managed on a *discretionary* basis and is provided ongoing supervisory and management services, and therefore receives continuous and regular supervisory or management services. (See Instruction 5.b.(3)).

Third, what is the entire value of the account? The entire value of the account ($10,000,000) is included in the calculation of the adviser's total regulatory assets under management.

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Key Regulatory Issues for Private Lending Funds

<u>Special Conflict Issues: Principal Transactions and Related Issues:</u>

- Many private lending funds started out as loan origination and servicing businesses
- Accordingly, many such funds continue to invest in loans originated and serviced by affiliates

Principal Transactions

Section 206(3) of The Act prohibits an adviser (whether SEC-registered or not), acting as principal for its own account, from knowingly selling any security to or purchasing any security from a client ("principal transaction"), without notifying the client in writing, and obtaining the client's consent before the completion of the transaction. Notification and consent for principal transactions must be obtained separately for each transaction.

Key Regulatory Issues for Private Lending Funds

<u>SEC's Recent Pronouncements on Conflicts:</u>

- Fees charged by fund managers directly to portfolio companies
  - *In re Blackstone Mgmt. P'rs*, (Oct. 7, 2015): $39MM in sanctions for PE Manager accelerating monitoring fees to portfolio cos. at time of IPO/private sale & getting legal discounts based on fund using law firm.
  - *In re Apollo Mgmt. V, L.P., et al.*, (Aug. 23, 2016): $52.7MM in sanctions for misleading disclosures about accelerating portfolio monitoring fees and loan from fund to Apollo Mgmt. affiliate.
    - Apollo only disclosed ability to charge monitoring fees in offering documents, but only disclosed acceleration of monitoring fees after investors committed capital and Apollo accelerated.
  - SEC charged severe penalties ($10MM Blackstone, $12.5MM Apollo) even though such fees were industry standard and despite absence of public investor lawsuits.

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Key Regulatory Issues for Private Lending Funds

<u>SEC's Recent Pronouncements on Conflicts:</u>

- Allocations of investment opportunities
  - *In re Welhouse & Associates* (June 29, 2015): A principal of the adviser executed a cherry-picking scheme by unfairly allocating options trades. In short, he disproportionately allocated those trades that had appreciated in value during the course of the day to his personal and business accounts, while allocating trades that had depreciated in value during the day to the accounts of his advisory clients. He did this by purchasing the options in an omnibus account and delaying allocation of the purchases until later in the day, after he saw whether the securities appreciated in value. Willful violations of Section 10(b) under the Securities Exchange Act of 1934 and Sections 206(1) and 206(2) under the Investment Advisers Act of 1940.

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Key Regulatory Issues for Private Lending Funds

SEC's Recent Pronouncements on Conflicts:

- Allocations of expenses among funds and affiliated entities
  - *In the Matter of Lincolnshire Mgmt*., Inc. (Sept. 22, 2014): Manager integrated two portfolio companies from two different Funds into one, joint company, but allocated expenses benefitting one Fund at expense of other.
  - SEC faulted Manager for failing on some occasions to follow expense allocation policy designed to address one of the two companies. $2.3MM in sanctions.
  - *In the Matter of Capital Advisors, LLC* (Nov. 23, 2015): Manager improperly charged fund for Manager's own expenses for attorney for compliance consulting (*i.e.*, registration and compliance program), and for office supplies, computers and utilities.
  - *In the Matter of Cherokee Investment Partners, LLC*, (Nov. 5, 2015): Manager improperly charged fund for compliance consultant expenses relating to registration and compliance consulting and legal expenses arising from SEC Exam and Investigation.

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Key Regulatory Issues for Private Lending Funds

SEC's Recent Pronouncements on Conflicts:

- *In re Alpha Titans, LLC* (Apr. 29, 2015): Action against a hedge fund manager that charged investors $500,000 in fund manager's office rent, employee salaries, etc. & engaged in $3MM in related-party transactions without clear disclosure.
- *In re Blackstreet Capital Mgmt. et ano*., (June 1, 2016): Improperly Charged PE fund for (i) broker fees for purchasing portfolio cos., without registering; (ii) $450K in oversight fees to 2 portfolio cos., (iii) for political/charitable contributions & entertainment expenses & (iv) improperly acquired shared in portfolio cos., & LP interests in PE fund from others, when should have been repurchased by cos. or reverted to fund to benefit fund & investors. $3.1MM sanctions.

Key Regulatory Issues for Private Lending Funds

<u>SEC's Recent Pronouncements on Conflicts:</u>

- Valuation Conflicts
  - *In re Platinum* (Dec. 19, 2016): The SEC stated that the Platinum funds overstated the value of an oil company that was among their largest assets, and they concealed a growing liquidity crisis by transferring money between the funds, making preferential redemptions to favored investors, and using misrepresentations to attract new investors to the struggling funds during what internal documents described as "Hail Mary time." The SEC requested a court-appointed receiver over certain funds managed by Platinum. Executives of Platinum were charged with a $1 Billion fraud that was compared to the Madoff Ponzi scheme in 2008 and the Petters scheme in 2009. The criminal case involves charges of securities fraud and investment adviser fraud, based on the unsealed indictment filed in Federal District Court in Brooklyn NY.

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IV. Further Structuring Considerations: ERISA/IRA Entities

ERISA Considerations Relating to Private Investment Funds

1. Plan Assets Issues; Fiduciary Status and Prohibited Transaction Issues

If the assets of an entity (e.g., a corporation, partnership or trust) are treated as plan assets of a benefit plan investor that owns an equity interest in such entity, the parties having management authority over the assets of such entity would be treated as fiduciaries under ERISA with respect to such plan investors. In addition, transactions entered into by such plan asset entities would be subject to ERISA scrutiny including complex prohibited transaction rules.

A. General Rules on Plan Assets Status

Under the ERISA plan assets regulations, the assets of an entity in which a plan has an **equity interest** will **not** be treated as plan assets if the equity interests are(1) **publicly traded securities or (2) a security issued by an investment company registered under the Investment Company Act of 1940.**

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ERISA Considerations Relating to Private Investment Funds (cont.)

In all other cases the assets of the entity will be treated as plan assets for ERISA purposes unless:

(1) the entity qualifies as an "**operating company**" which term also includes a "**venture capital operating company**" or a "**real estate operating company**"; **or**

(2) **the aggregate investment in the equity interests of the entity that are owned by "benefit plan investors" is less than 25 percent of the outstanding equity interests in such entity (the Insignificant Plan Investment Exception").**

<u>CAUTION</u>: An equity interest is defined as any interest in an entity <u>other than</u> an interest that is treated as indebtedness under local law and has "no substantial equity features".

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ERISA Considerations Relating to Private Investment Funds (cont.)

B. **Operating Company Definition**

An operating company is defined as an entity that is **"primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital."**

(1) Start-up Ventures and Companies Engaged Solely in Research and Development May not Qualify under this Definition.

(2) The Venture Capital Operating Company ("**VCOC**") and Real Estate Operating Company ("**REOC**") Exemptions Were Added Later.

CAUTION: The direct lending fund may not be considered an operating company until it is "up and running."

ERISA Considerations Relating to Private Investment Funds (cont.)

VCOC Definition

To qualify as a VCOC, the entity must satisfy two requirements: First, at least 50 percent of the entity's assets (at cost) must be invested in "**venture capital investments**" or "derivative investments" as defined. Second, the entity must obtain and exercise "management rights" with respect to at least one of its operating company investments. **The term "venture capital investment" is defined as an investment in an "operating company" in which the investing entity has obtained management rights.**

REOC Definition

The REOC definition is similar to the VCOC definition. In order to be a REOC, the entity must: (1) have at least 50 percent of its assets (valued at cost) "invested in **real estate that is managed or developed** and with respect to which such entity has obtained the right to substantially participate directly in the management or development activities"; **and (2) be directly engaged in real estate management or development activities.**

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