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PRIVATE FUNDS IN THE SPOTLIGHT: INTEGRATION AND LOOK-THROUGH – WHAT YOU NEED TO KNOW

For those financial professionals who wish to launch their first private fund, many begin their investment management business as an exempt adviser. If the fund (a) has no more than 100 investors and (b) and is not sold in a public offering, it will be exempt from investment company registration pursuant to Section 3(c)(1) of the Investment Company Act of 1940.

As the fund gains traction and the performance track record grows (hopefully in positive territory), demand for the fund may increase. If the number of investors investing and seeking to invest in the fund surpasses 100, the investment manager is faced with making some critical decisions.

Let's assume that to accommodate new investors, the investment manager seeks to create another fund believing that it, too, is exempt from registration pursuant to Section 3(c)(1). Over the next three years, the new fund's shareholders see their original investment more than double in value. The manager has earned $3 million in investment advisory fees and $11 million in performance fees.

Unfortunately, one day the manager receives a letter from a lawyer representing one of the fund's shareholders alleging that the manager has been unlawfully operating two unregistered investment companies, rendering the investment management agreements illegal, and demanding that you return forthwith the $14 million in investment management and performance fees you earned for the past 3 years in the new fund. A month later, the manager is notified of an investigation by the Securities and Exchange Commission ("SEC") looking into allegations as to whether the manager's funds should have been registered with the SEC as investment companies; whether the firm should have been registered with the SEC as an investment adviser; whether the firm or its principals violated a half dozen federal securities laws, which collectively could subject the manager and its principals to thousands of dollars in fines and penalties, not to mention disgorgement of the investment management and performance fees.

The principals review Section 3(c)(1) again and see the investment company exemption is available to funds that have no more than 100 shareholders and whose interests are not sold in a public offering. The firm's records identify 90 shareholders in the first fund and 80 shareholders in the second fund.

Unfortunately, there is a problem.

The trap that ensnared the manager lies in the concept of integration, or treating two or more like funds as one and counting the aggregate number of investors to determine whether they exceed 100. In our above example, if the manager launches the same type of fund, (*e.g.*, a second global macro fund) after the number of investors in the first fund reaches 100 and is closed, the SEC may, under certain circumstances, treat both funds as one 3(c)(1) fund. Consequently, once the investment adviser takes in the first investor in the second fund, neither fund will comply with section 3(c)(1). –

And if neither fund can fit within the exemption, then both are required to register as investment companies with the SEC.

There is no statute that addresses fund integration, and the SEC has not adopted any rule that outlines the triggers for integration. Guidance on integration, however, can be found in a number of SEC No-Action letters, which set forth the following tests which may lead to a finding that integration exists:

- Are the different offerings part of a single plan of financing?
- Do the offerings involve issuance of the same class of security?
- Are the offerings made at or about the same time?
- Is the same type of consideration to be received?
- Are the offerings made for the same general purpose?
- Would an interest in one fund be considered materially different from an interest in a second partnership by a reasonable investor qualified to purchase both?
- Do the funds have the same investment objectives, the same types of portfolio securities, and, particularly, similar portfolio risk return characteristics?

There have been several No-Action Letters where integration has not been found. For example, in *Oppenheimer Arbitrage Partners LP No-Action Letter* (pub. avail. Dec. 26, 1985), the SEC did not integrate a fund that was offered to tax exempt investors, and did not engage in short sales or write uncovered calls, with a fund that was offered to taxable investors and engaged in short sales and other leverage transactions.

In the *Welsh, Carson, Anderson & Stowe No-Action Letter* (pub. avail. June 18, 1993), the SEC did not integrate institutional funds being managed side-by-side with retail funds due to differences in the structure and operations of the funds, their portfolio composition and potential risk and returns. Among other things, one fund could use leverage and employ certain option and short-sale strategies while the other could not. There was very little overlap in the portfolio holdings. Finally, one fund had a performance fee while the other did not.

In the *Shoreline Fund No-Action Letter* (pub. avail. Apr. 11, 1994), the SEC did not integrate an offshore fund with an almost identically-managed onshore fund on the grounds that the offshore fund was created for non-U.S. and U.S. tax exempt investors, while the onshore fund was created for taxable U.S. investors.

Conversely, **In the Matter of Gerald Klein & Associates, Inc. and Klein Pavlis & Peasley Financial, Inc.** (Investment Advisers Act Rel. No. 2404 (Jul 8, 2005)), the SEC instituted administrative proceedings against two affiliated investment advisers for violations of the registration provisions of the Investment Company Act because the offerings of two funds to retail investors should have been integrated. In this case, Fund I and Fund II had similar investment strategies, except Fund II could have invested up to 15% of its assets in fixed income securities. The determinative factor seemed to be that despite the differences in investment characteristics on paper, in reality both funds held essentially the same investments.

In *Frontier Capital Management Company* (pub. avail. July 13, 1988), the SEC refused to grant no-action relief to three funds where one invested in a portfolio of large cap stocks, the other in a portfolio of small cap stocks, and the third in a balanced portfolio of stocks and bonds. The SEC noted that the three funds had similar investment objectives, may have similar or overlapping portfolios, and were designed for one group of investors with similar investment profiles. From the authorities cited above, determining whether funds will be integrated will be an intensive facts and circumstances analysis. Given the devastating consequences of integration, great care should be taken when creating side-by-side funds. To help avoid integration, the investment adviser should consider whether to tailor the funds for different groups of investors (*e.g.*, institutional, individual, taxable, non-taxable), and plan to construct the respective funds' portfolios so to minimize the overlap in holdings.

Another area to consider involves look through provisions. Let's assume that a manager starts as an exempt adviser, managing one fund with $60 million in assets under management and 80 shareholders. The offering of the fund has been private and, accordingly, the fund seems to fit within the Section 3(c)(1) exemption. One of the shareholders is organized as a limited partnership with 75 partners and $50 million of its own in assets, whose primary purpose is providing $7 million in seed monies for the fund. Over the next three years, the manager achieves positive performance, doubling the investors' money and earning for itself $2 million in advisory fees and $12 million in performance fees.

Unfortunately, the manager receives a similar investor complaint and SEC investigation, alleging illegal investment company and advisory activities, and seeking disgorgement of your advisory and performance fees. In accordance with the provisions of Rule 3c-1 of the Investment Company Act of 1940, generally, an entity that invests in a fund will be counted as one shareholder, *unless* that investor entity is itself an investment fund and owns 10% or more of the outstanding voting securities of the fund. In this particular case where the L.P. entity owns more than 10% of the fund, Section 3(c)(1) and Rule 3c-1 require the manager to look through the actual L.P. entity and count the 75 partners who own interests in the L.P. entity as shareholders of the fund. Because the total number of investors in the fund now stands at 154, the 3(c)(1) exemption is unavailable to the fund. As a result, the SEC may bring an enforcement case seeking disgorgement of fees, interest and civil fines. In addition, investors may seek reimbursement of all investment advisory and performance fees on the grounds the investment management agreement is illegal.

It is imperative that investment advisers remain wary of these considerations when formulating their private funds and plan accordingly. Having a strong "know your client" process and comprehensive questionnaire included in the fund's subscription agreement will be your best approach to avoid the negative consequences of look-through.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

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