Investment Company Act of 1940
Private Funds

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Investment Company Act of 1940

- The Investment Company Act of 1940 ("1940 Act") regulates "investment companies," i.e., entities engaged primarily in the business of investing and reinvesting in securities.
- The 1940 Act requires investment companies to register with the SEC and imposes extensive substantive regulations on registered entities, including:
  - Independent boards of directors
  - Investment and leverage restrictions
  - Extensive investor disclosure and SEC filing requirements
  - Limits on length and terms of management contracts
  - Restrictions on related party transactions
- Private funds avoid burdensome restrictions by qualifying for an exception from registration.
- The exceptions most relied upon for private equity and hedge funds are:
  - Section 3(c)(1)—Private investor funds
  - Section 3(c)(7)—Qualified purchaser funds
3(c)(1) Funds

- Section 3(c)(1) exception is available to any fund:
  - whose outstanding securities are beneficially owned by fewer than 100 persons, and
  - does not make a public offering of its securities
- Ownership applies to all securities, whether debt or equity, voting or non-voting (other than short term paper)
- Special counting rules:
  - Fund interests jointly owned by spouses treated as having one beneficial owner
  - Fund interests owned in spouses’ own names counted separately
  - No double counting if the same person holds through different investment vehicles
  - “Knowledgeable Employees” not counted toward limit:
    - Executive officers, directors and similar senior-level personnel
    - Employees and affiliates of the fund who participate in the investment activities of the fund
  - A company is treated as a single holder, unless:
    - The company holds 10% or more of the voting securities of the fund and is an investment company or itself a 3(c)(1) or 3(c)(7) fund
    - Ownership is then attributed to all the company’s securities holders, who must be separately counted toward the 100 person limit
- 3(c)(1) funds are permitted to pay performance fees to registered investment advisers only if all investors are “qualified clients” under the Investment Advisers Act (e.g., have a net worth of at least $2,000,000, etc.)
- Fund offerings must be conducted under Regulation D or Rule 144A of the Securities Act
3(c)(7) Funds

- Section 3(c)(7) exception is available to any fund:
  - whose securities are owned exclusively by “qualified purchasers”
  - does not make a public offering of its securities
- Qualified purchasers include:
  - Natural persons with not less than $5,000,000 in investments
  - Family companies with not less than $5,000,000 in investments
  - Trusts if trustees and settlors are qualified purchasers
  - Companies with not less than $25,000,000 in investments
  - Companies owned solely by qualified purchasers
  - Qualified institutional buyers (QIBs) under Rule 144A
  - “Knowledgeable Employees”
    - Executive officers, directors and similar senior-level personnel
    - Employees and affiliates of the fund who participate in the investment activities of the fund
- No limit on number of qualified purchasers or percentage ownership
- 3(c)(7) funds are permitted to pay performance fees to registered investment advisers
- Fund offerings must be conducted under Regulation D or Rule 144A of the Securities Act
Further Information

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