FAQs Regarding Private Equity Firms Launching Registered Funds

Many of our private equity clients have recently asked us about the feasibility of offering their investment strategies through registered fund products. We have set forth below some of the questions that we frequently receive.

1. What types of registered funds have been launched by private equity firms?

To date, private equity firms (including KKR this past July) have launched or filed to launch registered funds that leverage off of their activities for private funds, primarily with respect to strategies involving fixed income securities.

2. What is a registered fund?

It is a fund that has been registered as an investment company under the Investment Company Act of 1940 (commonly referred to as a mutual fund). It can take two forms – open-end (the fund engages in a continuous offering of shares, and investors have a right to daily redemption at net asset value) and closed-end (the fund, with limited exceptions, engages in a one-time offering of shares, investors have no redemption rights and the shares trade on a stock exchange).

3. What is the advantage of a registered fund?

Shares can be sold to retail investors (*i.e.*, there are no income, net worth, or sophistication requirements). Additionally, so long as certain requirements are followed, there are no restrictions on the manner and frequency of contact with potential investors (*i.e.*, general solicitation is permitted). Registered funds also may have unlimited lives, allowing for more flexibility in the timing and execution of strategies. In the case of closed-end funds described above, there is also a permanent capital base after a single fundraising. See below for a list of advantages and disadvantages of registered funds as compared to private equity funds.

4. What fees may be charged to a registered fund?

Most advisers charge only an asset-based fee to registered funds. Performance fees (or carried interest) generally may not be charged to a registered fund, unless all investors are "qualified clients" meeting certain wealth requirements. The only exception is that an adviser may charge a "fulcrum fee", where the fee increases or decreases proportionately with the performance of a fund in relation to the performance of an appropriate benchmark.

5. What other requirements are applicable to a registered fund?

There are a number of other requirements applicable to registered funds. For example, the funds must be governed by a board of directors, at least a majority of which are independent from the adviser. The board must approve the investment management agreement at least annually, and material changes must be approved by shareholders. There also limits on the ability to engage in leverage and to enter into transactions with affiliates. Registered funds must also file with the SEC and provide to potential investors a prospectus that meets certain requirements and (for open-end funds) update that prospectus on a regular basis, as well as provide periodic reports that are audited by independent public accountants. In addition, a registered fund must meet certain income, diversification and dividend tests required to receive favorable tax treatment (i.e., pass-through taxation with no tax at the fund level).

6. How can Ropes & Gray help?

Ropes & Gray is one of the few law firms with substantial expertise in both private equity and registered funds. This expertise positions us well to advise businesses that have previously sponsored only private funds and now plan to launch registered funds. Our longstanding leadership in these areas was recently recognized by *Chambers USA*, which awarded us a 2012 "Award of Excellence" for our investment funds practice.

Considerations for Launching Registered Funds

Advantages

- Ability to access retail investors (no income, net worth, or sophistication requirements)
- General solicitation permitted
- Indefinite term

For Closed-End Funds:

- Permanent capital

For Open-End Funds:

- Continuous offering (constant ability to raise additional capital)

Disadvantages

- (Generally) No performance fees
- Limited ability to engage in transactions with affiliates (*i.e.*, registered fund likely prohibited from investing in portfolio companies of the sponsor)
- Extensive and costly filings with the SEC
- Income and diversification tests must be met for favorable tax treatment
- Substantial restrictions on ability to engage in leverage
- Formal and rigid governance rules (*e.g.*, majority independent board of directors and certain shareholder approval rights)
- Extensive reporting and disclosure requirements

For Open-End Funds:

- Interests must be redeemable, hence need to maintain liquidity