Managers of private investment funds (Private Funds) commonly require or encourage their employees to invest in such funds, and employees of Private Fund managers often want to invest in the funds that they help manage. On both sides, this desire may spring from various reasons such as a belief in the management firm and its funds, a desire to show clients that the employees are aligned with them financially, or a belief that permitting employee investments will help the manager retain talented employees.

Employee investments in Private Funds may take a number of forms depending on the circumstances, the parties’ business goals, and applicable legal and tax considerations. For instance, the investment may be directly in a fund commingled with third-party investors or may be in an employee-only vehicle that invests in, alongside, or completely independently of such a fund. The source of the invested capital may be the employee’s own funds or may be a portion of the employee’s compensation from the manager (which may be required to be invested, often subject to a lock-up and deferral arrangements).

This article provides a brief overview of the principal legal and regulatory considerations of such investments under the US federal securities and commodities laws.

**Securities Act of 1933**

As a matter of first principles, absent facts requiring or permitting a different conclusion, an investment by an employee in a Private Fund typically involves an offer and sale of a security that must be either registered or exempt from registration under the Securities Act of 1933, as amended (Securities Act). There are a handful of exemptions and exclusions typically relied on by Private Funds in the context of employee investing.

**Daniel and Related SEC Releases**

In 1979, the US Supreme Court ruled that the Securities Act does not apply to pension plans in which participation is compulsory and to which employees need not contribute. In two subsequent releases in direct reaction to Daniel, the Securities and Exchange Commission (SEC) expanded on the ruling by setting forth its view that the Securities Act does not apply to any employee benefit plan (not just a pension or defined benefit plan) unless such plan is both voluntary and contributory. For this purpose, the Daniel Releases explain, a plan is a voluntary contributory plan if the participating employees “can decide at some point whether or not to contribute their own funds to the plan.” For example, 401(k) plans are voluntary in that employees may elect to participate but not contributory in that the employer makes the contributions to the plans for the benefit of its employees.

In the Private Funds context, managers often establish mandatory deferral programs pursuant to which employees are required to defer a significant portion of their compensation for a number of...
years. During the deferral period, this compensation may be deemed to earn returns indexed to one or more of the manager’s Private Funds or may actually be invested in such funds. Under the Daniel Releases, such a deferral program is not subject to the Securities Act due to its mandatory nature.⁵

**Securities Act Exemptions**

In cases where the Daniel Releases do not apply – for instance, where employees are making voluntary investments in Private Funds from their own assets – other exemptions from the Securities Act must be relied upon. The most commonly used exemption in the Private Fund context, Rule 506 of Regulation D under Section 4(a)(2) of the Securities Act, is also the most commonly used in the case of employee investments in Private Funds.

Rule 506 of Regulation D, as recently amended by the SEC pursuant to the Jumpstart Our Business Startups Act (JOBS Act), permits a Private Fund to offer and sell securities under two alternative routes: Rule 506(b) and Rule 506(c). The former permits sales to an unlimited number of “accredited investors” and up to 35 non-accredited investors, provided that neither the issuer nor anyone acting on its behalf engages in any form of general advertising or general solicitation in connection with the offering. The latter, newer provision of Rule 506 permits sales only to accredited investors, and requires the issuer to take reasonable steps to verify the accredited status of such investors, but permits general advertising and general solicitation in connection with the offering. For a number of reasons, including the requirement to furnish certain information to non-accredited investors that may be hard to satisfy for an existing Private Fund, managers of Private Funds typically do not sell to non-accredited investors even when relying on Rule 506(b). As a result, employees investing in Private Funds must typically meet the accredited investor standard, which requires (in the case of an individual) that the investor have either (i) net worth, or joint net worth with the person’s spouse, that exceeds $1 million at the time of the purchase, excluding the value of the primary residence of such person or (ii) income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years, and a reasonable expectation of the same income level in the current year.⁶

Alternatively, employees that are not “U.S. persons” within the meaning of Rule 902(k) of Regulation S under the Securities Act may invest in a Private Fund without meeting the accredited investor requirement, assuming that the other conditions of Regulation S are met.

**Investment Company Act of 1940**

**Private Funds**

As noted above, employees may invest in a fund commingled with third-party investors or in an employee-only vehicle. In either scenario, in order for employees to invest in a Private Fund, the applicable conditions of Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940, as amended (Company Act) would have to be satisfied. Most importantly, in the case of a 3(c)(1) Private Fund, there may be no more than 100 beneficial owners, and in the case of a 3(c)(7) Private Fund, all of the beneficial owners must be “qualified purchasers,” as defined in Section 2(a)(51) of the Company Act and the rules thereunder. “Knowledgeable employees,” as defined in Rule 3c-5 under the Company Act, do not count toward the 100 person limit in the case of a 3(c)(1) Private Fund and do not need to be qualified purchasers in the case of a 3(c)(7) Private Fund. To be a qualified purchaser, an employee must have $5 million of investments (as defined). (The term “qualified purchaser” also includes entities that have $25 million of investments.) To be a knowledgeable employee, an employee generally would have to be a senior level management person of a principal business unit or a portfolio manager type employee that has been performing investment advisory functions for at least 12 months.⁷ In addition, Private Funds must satisfy the conditions of the private placement...
exemption under the Securities Act as described above, which generally would require employees to be “accredited investors” in order to invest in the funds in the case of an offering under Regulation D.

Private Funds also pose look-through issues under both Sections 3(c)(1) and 3(c)(7). An entity that is formed for the purpose of investing in a 3(c)(1) Private Fund will be looked through and each of the beneficial owners of that entity will be counted toward the 100 person limit. Similarly, an entity that is formed for the purpose of investing in a 3(c)(7) Private Fund will be looked through and each of the beneficial owners of that entity will need to be a qualified purchaser or a knowledgeable employee. In general, an entity is presumed to be formed for the purpose of investing in a Private Fund if 40 percent or more of such entity’s assets are invested in the Private Fund. For example, a manager could not structure an employee fund as a 3(c)(1) Private Fund for the purpose of investing all of its assets in a 3(c)(7) Private Fund advised by the manager without having to look through the employee fund and ensuring that each investor therein is a qualified purchaser or a knowledgeable employee. In addition, assuming that the look-through does not pose an issue, the employee fund investing in the 3(c)(7) Private Fund would itself need to be a qualified purchaser, meaning, in most instances, that it would need at least $25 million to invest. A Private Fund that invests in a 3(c)(1) Private Fund will also be looked through if the investing Private Fund owns 10 percent or more of the 3(c)(1) Private Fund’s outstanding voting securities.8

As a result of the foregoing limitations, some managers find that investment in Private Funds by a broad range of employees is impractical. Most large managers are likely to exceed the 100 person limit if they allowed all of their employees to invest in a 3(c)(1) Private Fund, especially if commingled with third-party investors. In addition, many of their employees may not be qualified purchasers or knowledgeable employees eligible to invest in a 3(c)(7) Private Fund.

**Employees’ Securities Companies**

To avoid such difficulties, some managers seek an exemptive order from the SEC for what is called an “employees’ securities company” (ESC). An ESC is an investment company all of the outstanding securities of which are held by current and former employees, their immediate family members, and the ESC’s manager and its affiliates.9 Most ESCs limit their investors to accredited investors (some also permitting up to 35 non-accredited investors that meet certain sophistication requirements). ESCs can be structured to invest either alongside a Private Fund or to feed into one or more Private Funds, depending on the terms and conditions of the applicable exemptive order. Although an ESC that feeds into a single Private Fund would typically be formed for the purpose of investing in the Private Fund, the SEC Staff has stated that the look-through principle described above would not apply in the case of an ESC investing in a 3(c)(1) Private Fund so long as it owns less than 10 percent of the 3(c)(1) Private Fund’s outstanding voting securities.10 The SEC Staff has also provided guidance that the look-through rules described above would not be applied in the case of certain trusts formed by employees of a manager for the benefit of non-employee beneficiaries that hold interests in a 3(c)(1) Private Fund, provided that the beneficiaries’ participation in such trusts is involuntary and noncontributory.11

Technically, an ESC is an “investment company.” However, the ESC order exempts it from having to comply with most of the provisions of the Company Act. Clearly, the benefit of an ESC over a Private Fund is that an ESC is not restricted by the number of beneficial owners or the eligibility criteria of the employees. The downside, however, is that it can take years from the original date of application to obtain an ESC order from the SEC (although an ESC will be exempt from all applicable provisions of the Company Act pending final determination of its application by the SEC).12 Moreover, ESC orders are subject to a number of conditions, typically including certain restrictions on the ESC’s ability to engage in transactions with its...
affiliates and the requirement to deliver certain reports to investors. This means, for example, where an ESC is structured to invest side by side with a Private Fund advised by the same manager, conditions in the ESC order will require the manager to make a determination that the terms of the investments are fair and reasonable, do not involve overreaching, and are consistent with the interests of the ESC.

Investment Advisers Act of 1940

Under the Investment Advisers Act of 1940, as amended (Advisers Act), a manager that is registered with the SEC as an investment adviser may generally not charge performance-based compensation to persons who are not “qualified clients” as defined in Rule 205-3 under the Advisers Act. To be a qualified client, an investor must have at least $1 million under the management of the manager, or have a net worth (together with assets held jointly with a spouse, if applicable) of more than $2 million excluding the value of the investor’s primary residence. The term “qualified client” includes certain employees of the manager who serve in senior management roles or have been performing investment advisory functions for at least 12 months.13 (Although such employees generally would be the same employees that meet the definition of “knowledgeable employees” under the Company Act, this may not always be the case because the language used in Company Act Rule 3c-5 differs from the language used in Advisers Act Rule 205-3.)

While most managers do not charge fees to their employees, some do. Moreover, even managers that do not charge performance-based compensation to current employees may charge performance-based compensation to former employees. Managers who charge performance-based compensation should keep in mind that in order to comply with Rule 205-3 under the Advisers Act, they would need to determine the “qualified client” status of their employees. Managers may want to consider mandatory withdrawal rights so that they have the option of mandatorily withdrawing a terminated employee who does not meet the qualified client definition.14

Securities Exchange Act of 1934

Section 12(g) of the Securities Exchange Act of 1934, as amended (Exchange Act), requires issuers to register a class of equity securities if, on the last day of its fiscal year, (x) such class of securities was held of record by either (i) 2,000 persons or (ii) 500 persons who are not accredited investors, and (y) the issuer had total assets of more than $10 million.15 Prior to the signing of the JOBS Act, managers faced the prospect of having to register under the Exchange Act when a Private Fund edged close to having 500 owners of record. The JOBS Act increased this threshold by permitting an issuer to have up to 2,000 record owners who are accredited investors. It is not clear, however, when the determination should be made with respect to a record owner’s accredited investor status. Under Regulation D, accredited investor status is determined at the time an investor purchases an interest in a Private Fund. If continuous monitoring is required for purposes of Section 12(g), then it may not be practical for a Private Fund to rely on the 2,000 person limit.

Prior to the JOBS Act, the SEC had issued no-action letters to ESCs seeking to exceed the 500 person limit.16 In general, the conditions imposed by these letters for granting the no-action relief are more limiting than those needed for becoming an ESC (for example, only a subset of the participants eligible to invest in an ESC pursuant to the order may invest in the ESC if relying on the no-action letters, and the ESC must furnish investors with additional reports and information beyond those that the ESC is required to provide pursuant to the order). This no-action relief previously granted to ESCs is less likely to be needed given the increased Section 12(g) limits under the JOBS Act.

Commodity Exchange Act

In the case of a Covered Fund that invests in commodity interests (a term which now includes
many swaps), a manager of a Private Fund will also need to coordinate employee investments with the fund’s approach to compliance with the commodity pool operator rules under the Commodity Exchange Act. In the case of Private Funds relying on CFTC Rule 4.13(a)(3), each employee investor will need to be an accredited investor (as defined for purposes of Regulation D), a trust formed by an employee who is an accredited investor for the benefit of family members, a “knowledgeable employee” or a “qualified eligible person.” In the case of Private Funds relying on CFTC Rule 4.7, each employee investor will need to be a “qualified eligible person.”

Under the CFTC’s Part 4 regulations, the term “knowledgeable employee” is defined differently from, and more broadly than, such term is defined for purposes of Rule 3c-5 under the Company Act and as a result encompasses more clerical, administrative and other employees. An employee that qualifies as a knowledgeable employee under either the CFTC definition or the SEC definition is also deemed to be a qualified eligible person and is therefore eligible to invest in a Rule 4.7 Private Fund, as are employees who qualify as qualified purchasers within the meaning of Section 2(a)(51) of the Company Act or non-United States persons within the meaning of CFTC Rule 4.7.

Volcker Rule

In addition to the limitations imposed by the securities and commodities laws, fund managers subject to the Bank Holding Company Act must take into account the restrictions on employee investments in such managers’ Private Funds that are imposed under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act and its implementing regulations (Volcker Rule). Under the Volcker Rule, investment in Private Funds managed by such a manager is limited to employees who are “directly engaged in providing investment advisory, commodity trading advisory, or other services” to such fund. Permitted employee investors under this provision include, according to the regulation’s adopting release, “employees who provide services that enable the provision of investment advice or investment management, such as oversight and risk management, deal origination, due diligence, administrative or other support services.”

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NOTES

1 As used herein, the term Private Funds encompasses hedge funds, private equity funds and other investment funds not registered under the Company Act (defined below), in reliance on § 3(c)(1) or § 3(c)(7) thereof.

2 In addition to federal securities and commodities laws, this article touches briefly on the Volcker Rule. However, a complete exploration of the implications of such investments under banking law is beyond the scope of this article. Similarly, this article does not address the numerous considerations applicable to such investments under tax law and the Employee Retirement Income Security Act of 1974, nor does it address state “blue sky” laws.


5 However, neither Daniel nor the Daniel Releases expressly extends to the Company Act.

6 In the case of an employee investing through a trust (e.g., for the benefit of the employee’s children), the trust must not have been formed for the purpose of making the investment and must have assets in excess of $5 million.

7 The SEC recently issued extensive guidance on Rule 3c-5 in the form of a no-action letter to the Managed Funds Association. Managed Funds Association,

The 10 percent look-through applies when the investing entity relies on either § 3(c)(1) or § 3(c)(7). It does not apply when the underlying fund relies on § 3(c)(7).

Company Act § 2(a)(13).


Company Act Rule 6b-1.

Advisers Act Rule 205-3(d)(1)(iii).

We note that, rather than flipping the former employee into a fee-paying class, many managers routinely require the complete withdrawal from their funds of persons no longer employed by the manager.

Foreign private issuers are not required to register if the class of securities is held by fewer than 300 record holders residing in the United States. Exchange Act Rule 12g3-2(a).


See CFTC Rule 4.7(a)(vii).