Permanent Capital Investment Vehicles

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David concentrates his practice on tax issues related to the formation and operation of onshore and offshore investment funds and their investment managers, as well as tax issues that prospective investors face with such investments, tax considerations related to employee and executive compensation, including deferred compensation programs and partnership taxation.

Recognized by *The Legal 500 US* as a leading tax lawyer, David has spoken on tax issues related to running investment management firms and their funds, as well as hedge fund tax considerations and compensation structures. He contributed to “Hedge Fund Employee Compensation,” published by Practical Law, and *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press). David regularly presents on the topic of “Hedge Funds” at PLI’s Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances conferences. He is a member of the American Bar Association and the New York State Bar Association.

David holds an LL.M. in taxation and a J.D., *magna cum laude*, from New York University School of Law, where he was a Florence Allen Scholar and Order of the Coif, and an A.B., *cum laude*, from Harvard University.

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John represents private equity firms, hedge funds and other financial sector participants in a wide range of capital markets and securities law matters. He regularly assists clients in connection with the establishment and operation of business development companies, registered closed-end funds and other similar public and private vehicles that comply with complex regulatory structures, including the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Dodd-Frank Act. John has been involved with more than 100 debt and equity offerings, including over 20 IPOs, reflecting an aggregate of over $10 billion in total proceeds. His work in securities law and mergers and acquisitions includes providing guidance to many New York Stock Exchange and Nasdaq-listed companies in connection with ongoing corporate governance and U.S. Securities and Exchange Commission reporting and compliance matters. John also routinely handles issues involving tender offers, proxy solicitations, going-private transactions and beneficial ownership reporting obligations.

John is a recipient of the SEC Capital Markets Award, and he was named a *Washington, D.C. Super Lawyers* "Rising Star." He serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. He has spoken and written on topics ranging from SEC regulations and disclosure obligations to public and private capital raising structures, 1940 Act regulated funds and M&A issues. Recently, John addressed "What Alternative Investment Managers Need to Know" about managing 1940 Act regulated funds at an SRZ webinar.

John holds a J.D. from Georgetown University Law Center and a B.S.B.A., *cum laude*, from the University of Richmond, where he was a member of Beta Gamma Sigma.

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Omoz focuses his practice on the representation of sponsors and investors in the formation and structuring of private equity funds, hedge funds and hybrid funds. He also advises investment managers on strategic transactions involving alternative asset management businesses. Omoz has extensive experience representing sponsors and investors on funds employing credit, distressed investment, buyout, real estate, special opportunities, structured products, activist, multi-strategy and quantitative strategies. He has advised clients on spin-out transactions, acquisitions of minority stakes in hedge fund and private equity firms, joint ventures between investment management firms and strategic transactions involving a change of management of private investment funds. Omoz also represents hedge fund managers and investors in the negotiation of seed-capital transactions, and advises sponsors of private equity firms and hedge fund firms in the structuring of complex carry-sharing arrangements among principals and employees. His recent representations include institutional sponsors and boutique firms in the formation of private equity funds, hedge funds and hybrid funds; lead investors on their investments in private equity funds; hedge fund managers and investors in seed-capital arrangements; investment managers in joint venture arrangements; and investment managers and investors in the formation of special purpose acquisition and co-investment vehicles.

Omoz is recognized as a leading lawyer by *The Legal 500 US* and he regularly speaks at industry events covering current developments impacting private investment funds. Omoz also contributed to the *Fund Formation and Incentives Report* (Private Equity International in association with SRZ) and authored the article “Investor Remedies: The Importance of Key-Person Provisions,” published in *Law360*. Most recently, he was featured in the article “Ringing the Changes,” published in leading private equity magazine *Private Funds Management*.

Omoz received his J.D. from University of Michigan Law School and his B.A., *with highest honors*, from Michigan State University.

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Permanent Capital Investment Vehicles

I. Overview

A. Characteristics of Permanent Capital Vehicles

1. Longer-term or perpetual life investment vehicles.
2. Limited redemption rights, if any.
3. Includes products regulated under the Investment Company Act of 1940 ("1940 Act"), such as business development companies and registered closed-end funds, as well as non-1940 Act vehicles, such as real estate investment trusts, special purpose acquisition companies and offshore traded funds.

B. Benefits of Permanent Capital

1. Eliminates redemption risks and provides a perpetual supply of capital.
2. Eliminates limited fund life concerns.
3. Allows for managers to pursue longer-term strategies and target longer return profiles on investments.
4. Provides access to follow-on public debt and equity offerings.
5. Provides similar management fee and carried interest/incentive compensation structures to more traditional private investment funds (i.e., hedge funds and private equity funds), while providing greater consistency in management fees due to less AUM fluctuation.
6. 1940 Act products provide access to retail investors.

C. Types of Permanent Capital Vehicles

1. 1940 Act Regulated Funds

(a) Business development companies ("BDCs")

(i) Description. 1940 Act regulated fund subject to less restrictive regulation that invests primarily in U.S.-based private companies.

(ii) Pros

(1) Shares may be publicly traded.

(2) Able to charge incentive fees on realized and unrealized capital gains.

(3) Can use greater leverage than a registered closed-end fund.[1]

(iii) Cons

(1) Required to file Form 10-Ks and 10-Qs like operating companies.

(2) Must invest at least 70 percent of assets in "eligible portfolio companies" – typically U.S.-based non-public issuers.[2]

(iv) Tax treatment: Eligible to elect "regulated investment company" ("RIC") tax status for federal income tax purposes.

(1) RICs issue 1099s to investors and not K-1s.

(2) Unrelated business taxable income ("UBTI") is blocked for tax-exempt investors.

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[1] *See* Section II.C.2 *infra.*

[2] *See* Section II.A.3 *infra*.

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(3) Effectively connected income (“ECI”) is generally blocked for non-U.S. investors, with interest related dividends generally not subject to U.S. withholding taxes.

(v) Corporate governance. Under 1940 Act requirements, must maintain a majority independent board.

(b) Registered closed-end funds

(i) Description. Investment fund that is registered under the 1940 Act; issues shares that are not redeemable at the option of the investor.

(ii) Pros

(1) Can be publicly traded.

(2) If publicly traded, no restriction on investors that can acquire shares.

(3) Permits both domestic and offshore investments.

(iii) Cons

(1) Publicly traded CEFs cannot charge incentive fees on realized and unrealized capital gains.

(2) Ability to use leverage is greatly reduced relative to a BDC.

(iv) Tax treatment. Eligible to elect RIC status for federal income tax purposes.

(v) Corporate governance. Under 1940 Act requirements, must maintain a majority independent board.

(c) Non-traded regulated funds

(i) Description. Non-exchange listed version of a BDC or closed-end fund.

(ii) Pros

(1) Free from market price fluctuation.

(2) Offerings can be conducted publicly or as private placements.

(iii) Cons

(1) Retail versions require large distribution networks.

(2) Publicly offered versions can be subject to state “blue sky” laws.

(3) Liquidity requirements mandate periodic repurchase offers.

(iv) Tax treatment. May be RICs or partnerships for federal income tax purposes, depending on the circumstances.

(v) Corporate governance. Under 1940 Act requirements, must maintain a majority independent board.

2. Structured Holdco Acquisition Companies (“SHACs”)

(a) Description. Holding company structure that acquires controlling interests in one or more operating companies.

(b) Pros

(i) Typically publicly traded.

(ii) No restriction on investors that can acquire shares.

(iii) Not subject to 1940 Act obligations.

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(c) Cons

(i) Required to file Form 10-Ks and 10-Qs like operating companies.

(ii) Limited in its ability to acquire non-controlling investments.

(d) Tax treatment. By satisfying an income test, may qualify as a partnership for federal tax purposes even if publicly traded.

(i) Depending on the nature of the assets, subsidiary corporations may be needed for the SHAC to generate the income needed to meet the qualifying income test.

(ii) As a partnership, a SHAC must provide investors with annual K-1s.

(e) Corporate governance. Under exchange listing requirements, must typically maintain a majority independent board.

3. Special Purpose Acquisition Companies ("SPACs")

(a) Description. Shell company that raises capital through an initial public offering to acquire an operating company.

(b) Pros

(i) Typically publicly traded.

(ii) No restriction on investors that can acquire shares.

(iii) Large pool of capital can help minimize the need for debt financing for acquisitions.

(iv) Sponsors typically hold a significant equity position post-acquisition.

(c) Cons

(i) SPACs are fixed life span vehicles, which must return their capital if no acquisition is consummated by the applicable deadline.[3]

(ii) Required to file Form 10-Ks and 10-Qs like operating companies, even when assets consist solely of cash.

(iii) SPACs are treated as "shell companies" for SEC regulatory purposes, which further restricts the resale of their securities.

(d) Tax treatment. Taxed as "C Corporations" for federal income tax purposes.

(e) Corporate governance. Under exchange listing requirements, must typically maintain a majority independent board.

4. Offshore Traded Funds ("OTFs")

(a) Description. Offshore investment fund listed on non-U.S. exchanges, typically in London or Amsterdam, that mirrors a U.S.-regulated fund in its operations.

(b) Pros

(i) Publicly traded.

(ii) If structured properly, OTFs are not subject to 1940 Act reporting and compliance requirements, including restrictions on leverage, liquidity or investment strategy.

(iii) OTFs can raise public capital from non-U.S. investors, as well as private capital from U.S.-based qualified purchasers.

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[3] *See* Section VICK *infra*.

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(iv) Able to charge an incentive fee or carried interest.

(c) Cons

(i) Shares are subject to transfer restrictions with respect to ownership by U.S. persons and U.S. retail investors are unable to participate.[4]

(ii) OTFs must navigate offshore regulatory and listing requirements.

(iii) Liquidity and investor participation may fall below that of typical U.S.-listed regulated funds.

(d) Tax treatment

(i) Non-U.S. taxation driven by country of incorporation and operation.

(ii) U.S. taxation

(1) If a partnership, the entity will need to meet the qualifying income test.

(2) If a corporation, the entity will likely be a "passive foreign investment company" ("PFIC").

(e) Corporate governance. Board independence requirements driven by country of incorporation and foreign exchange requirements.

5. Real Estate Investment Trusts ("REITs")

(a) Description. Investment funds that invest primarily in physical real estate and real estate-related securities.

(b) Pros

If structured properly, REITs are not subject to 1940 Act reporting and compliance requirements.

(c) Cons

(i) REITs can only invest a small percentage of their assets in non-real estate-related securities.[5]

(ii) Required to file Form 10-Ks and 10-Qs.

(d) Tax treatment. Must meet various requirements, including type of income and assets, to be treated as a "REIT" for federal tax purposes.

(e) Corporate governance. Under exchange listing requirements, must typically maintain a majority independent board.

D. Permanent Capital Investment Strategies

1. Key focus is typically on income-producing portfolios that can generate attractive dividend yields for investors.

2. Strategies typically include:

(a) Credit strategies, particularly in the high-yield space;

(b) Cash flow-focused strategies that target control investments with attractive cash flow potential;

(c) For REITs, real estate strategies that focus on commercial or residential mortgages or rental income properties;

(d) Capital gains-focused strategies that target short-term (i.e., less than one year) realized capital gains; and

[4] *See* Section VIII.B.3 *infra*.

[5] *See* Section IX.A.2 *infra*.

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(e) Other strategies that target high ROI levels with significant income component.

II. Business Development Companies

A. What Are BDCs?

1. Special type of closed-end fund that elects to be regulated, rather than registered under the 1940 Act.

   (a) Shares can be offered publicly and may be listed on an exchange.

   (b) Can also be offered in a private placement.

2. Hybrid between a public finance company and a registered investment company from a regulatory perspective.

3. In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets.[6]

   (a) Typically U.S.-based non-public operating companies.

   (b) Extends to listed companies with market capitalizations of less than $250 million.

   (c) Excludes "investment companies," including most private funds.

4. A BDC must have at least a 200 percent asset coverage ratio (total assets/total debt) at the time of any new borrowings (less stringent requirement than for 1940 Act registered funds).

5. BDCs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional operating companies.

6. If not publicly traded, BDC public offerings are subject to "blue sky" registration in each state where an offering will be made.

B. Benefits of the BDC Model

1. Not required to limit the number of its investors or sell its shares only to qualified purchasers.

   A BDC making a public offering can advertise and sell its shares to investors who are not accredited investors.

2. Provides access to public capital markets.

3. Securities can be listed on national securities exchanges.

4. Availability of tax treatment as an RIC, which generally avoids entity-level taxation.

5. External model permits management fee and incentive fee structures similar to traditional private fund structures.

   Can charge a performance fee without limiting investors to qualified clients.

6. Increased transparency from publicly available quarterly financial information.

7. Certain offshore and tax-exempt investors can invest directly, rather than through offshore blockers.

C. Other Considerations

1. Federal Tax Compliance. BDCs need to comply with applicable diversification and source of income requirements as RICs. Income must generally be distributed as earned.

2. Leverage Restrictions. BDCs have limits on their use of leverage, and must maintain a 200 percent asset coverage ratio.[7] Those restrictions limit the ability to invest in lower-yielding investments where significant leverage would be required.

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[6] *See* Section 55(a) of the 1940 Act.

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3. Restrictions on Transactions With Affiliates. BDCs have specific restrictions on acquiring or selling assets to affiliates and on participating in co-investment transactions with affiliates.[8] Asset manager may need to obtain SEC exemptive relief to permit even pro rata investment allocations involving a BDC.
4. Public Reporting Requirements. Subject to periodic reporting requirements with the SEC that mirror those applicable to publicly traded operating companies (i.e., on Forms 10-Q and 10-K). BDCs must comply with additional compliance requirements under the 1940 Act, including with respect to:
    - (i) Custody of assets;
    - (ii) Maintenance of records;
    - (iii) Appointment of a chief compliance officer; and
    - (iv) Restrictions on holding securities of asset managers, broker-dealers and other investment companies.
5. Managerial assistance
    - (a) BDCs must "make available" to their investee companies "managerial assistance" (e.g., offer to serve on the company's board or to provide strategic consulting).
    - (b) A BDC may be compensated for providing these services.

III. Registered Closed-End Funds ("CEFs")

A. What Are Registered Closed-End Funds?

1. Closed-end fund that registers under the 1940 Act.
2. Can be publicly offered, publicly traded or privately offered.
3. Unlike BDCs, CEFs generally have fewer 1940 Act limitations on nature and type of investments.
    - (a) Can be used to deliver various types of alternative investment programs.
    - (b) Fund structures include single manager/strategy funds (e.g., long/short, market-neutral, hedged equity), multi-manager alternative funds, private equity funds, funds of hedge funds and funds of private equity funds and real asset/commodities funds.
4. As a result of greater investment flexibility, CEFs are often used by asset managers in lieu of a BDC structure to allow offshore or other investments that would be considered "bad" BDC assets.
5. Unlike a registered fund organized as an open-end fund (i.e., a mutual fund), registered closed-end funds do not offer redeemable securities.
    - (a) Enables greater control over the timing of cash flows to/from a fund.
        - (i) Can be appropriate structure for funds that invest in illiquid securities.
        - (ii) Also appropriate for alternative investment strategies where dealing with daily cash flows might adversely affect investment performance.
    - (b) If listed on an exchange, can provide daily liquidity to investors without impacting cash flows.
    - (c) Can also provide liquidity similar to the liquidity of an investment in a hedge fund by means of repurchase offers made by the fund, or can provide liquidity similar to the liquidity of an investment in a private equity fund by providing liquidity (by making distributions to investors) only as the fund's investments are sold or become liquid.

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[7] *See* Section 61(a) of the 1940 Act.

[8] *See* Section 57 of the 1940 Act.

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6. A CEF must have at least a 300 percent asset coverage ratio (total assets/total debt) at the time of any new borrowings.[9]
7. A CEF must have at least a 200 percent asset coverage ratio (total assets/(preferred stock + total debt)) at the time of issuing any new preferred stock.
8. Incentive fees on realized capital gains are generally prohibited.
9. Public reporting requirements include an annual and semiannual report, along with a publicly filed schedule of investments on off quarters.
10. Public offerings by non-traded CEFs are subject only to notice filings under state "blue sky" laws.

B. BDCs vs. CEFs

1. Business Development Companies
   (a) Allow greater leverage than typical registered closed-end funds.
       Limit of "one-to-one" debt to equity vs. "one-to-two" debt to equity.
   (b) Permit use of capital gains incentive fees for asset managers.
   (c) Provide slightly greater flexibility for transactions with remote affiliates.
   (d) Greater leverage permits investment in more liquid credit instruments, which lower unleveraged returns.
2. Registered Closed-End Funds
   (a) Allow hedge funds or funds of funds to have broader investor bases, without relying on 3(c)(1) or 3(c)(7).
   (b) Permit an asset manager to target novel or unique asset classes that would be ineligible in a BDC structure.
   (c) Frequently target investments in existing leveraged products or where significant leverage at the fund level is unnecessary.
   (d) Reduced state "blue sky" compliance for non-traded vehicle structures compared to BDCs.
   (e) Require a reduced public reporting burden compared to a BDC structure.

IV. Non-Traded Regulated Funds

A. What Are Non-traded Regulated Funds?

1. Structured as a BDC or registered closed-end fund and regulated by the 1940 Act.
2. Shares are not listed on an exchange.
   (a) Offerings can be conducted publicly or as private placements.
   (b) Shares sold through continuous offerings, with periodic closings, up to preset maximum amount.
3. Limited liquidity offered to investors through periodic repurchase offers.
4. Typically have fixed five- to seven-year period before exchange listing or traditional IPO.
5. Can be treated as an RIC or a partnership (with liquidity limitations) for tax purposes.

B. Non-Traded Regulated Fund Structures

[9] *See* Section 18(a) of the 1940 Act.

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Non-traded regulated funds are generally structured as a combination of an investment adviser or sub-adviser and a distributor, often using a joint venture format for the investment manager to the fund.

1. KKR Asset Management is the investment sub-adviser for Corporate Capital Trust, while CNL Fund Advisers serves as the dealer manager.
2. Apollo Global Management serves as investment sub-adviser for CION Investment Corp., while ICON Securities serves as the dealer manager.
3. SIC Advisers (investment personnel of Medley) is the investment adviser to Sierra Income Corporation, while SC Distributors is the dealer manager.

C. Non-Traded Regulated Fund Examples

1. Business Development Corporation of America
2. Business Development Corporation of America II (affiliated with AR Capital)
3. CION Investment Corporation (affiliated with ICON Capital Corp. and Apollo Global Management)
4. Corporate Capital Trust (affiliated with CNL Fund Advisors Company and KKR Asset Management)
5. FS Energy and Power Fund (affiliated with GSO/Blackstone)
6. FS Energy and Power Fund II (affiliated with GSO/Blackstone)
7. FS Investment Corporation II (affiliated with GSO/Blackstone)
8. FS Investment Corporation III (affiliated with GSO/Blackstone)
9. HMS Income Fund (affiliated with Hines Securities and Main Street Capital Corporation)
10. MacKenzie Realty Capital (affiliated with MacKenzie Capital Management)
11. NexPoint Capital (affiliated with NexPoint Advisors and Highland Capital Funds Distributor)
12. Sierra Income Corporation (affiliated with Medley Capital and SC Distributors)
13. VII Peaks Co-Optivist Income BDC II (affiliated with VII Peaks Capital)

V. Private BDCs

A. What Are “Private” BDCs?

1. Often sponsored by credit platforms with an existing institutional or high-net-worth investor base.
2. Operates similar to a traditional BDC from a public reporting and compliance perspective, but draws down capital via a capital call model, similar to a private fund structure.
   (a) Investors provide capital commitments, rather than complete funding up front.
   (b) Capital call structure helps mitigate the drag caused by excess uninvested cash.
3. Shares are offered through a private placement offering to the sponsor’s existing investor base.
   (a) Marketing efforts are similar to raising a traditional fixed-life credit fund.
   (b) Onshore and offshore investors can invest in the same vehicle directly.
4. Rather than having a fixed investment period, a private BDC will generally target an initial public offering, exchange listing or merger transaction with an existing public vehicle as a liquidity event for its investors.
   (a) Sponsor can maintain optionality to wind down in lieu of a liquidity event.
   (b) With appropriate structuring, a private BDC can be merged with an existing publicly traded BDC managed by an affiliated adviser, with only board approval required at the publicly traded BDC level.

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B. Advantages of the Private BDC Model

1. BDC/RIC structure helps mitigate the need for offshore feeder fund structures for foreign/tax-exempt investors.

   (a) Onshore and offshore investors can invest directly in the same vehicle.

   (b) Marketing and offering efforts are simplified, with only one PPM and subscription agreement.

   (c) Provides investors with greater transparency and the 1940 Act protections that they lack with a traditional private fund.

2. If structured properly, Rule 17a-8 can permit the roll-up of the private BDC with a publicly traded affiliate BDC, helping to grow a single pool of permanent capital.[10]

   (a) Provides an alternative to traditional public offerings to grow AUM for an existing publicly traded BDC.

   (b) With appropriate co-investment relief in place, a private BDC can co-invest alongside an existing publicly traded BDC managed by an affiliated adviser from inception.

3. Private placement structure eliminates the need for the "blue sky" registration process faced by non-traded BDCs.

   Arguably provides a more efficient offering structure than non-traded BDC public offerings.

C. Private BDC Sponsors

Numerous private BDCs have been formed in recent years, including:

1. Carlyle GMS Finance
2. TCW Direct Lending
3. Owl Rock Capital Corp.
4. Crescent Capital BDC Inc.
5. Bain Capital Specialty Finance

VI. Structured Holdco Acquisition Companies

A. What Is a Structured Holdco Acquisition Company?

1. Externally managed publicly traded holding company structure that holds controlling interests in its underlying operating company subsidiaries.
2. Hybrid between a publicly traded holding company and a private equity fund from a regulatory perspective.
3. Typically structured as a publicly traded limited liability company.
4. Top tier holding company holds controlling interests in one or more operating companies.
5. LLC holding company structure provides access to partnership tax treatment.
6. LLC is required to deliver K-1s to its public equity holders, similar to master limited partnership vehicles.
7. The LLC holding company is not subject to registration as an investment company under the 1940 Act.
8. SHACs have been listed on both the NYSE and Nasdaq.
9. SHACs have also conducted successful follow-on equity offerings to fund additional acquisitions.

[10] *See* Rule 17a-8 under the 1940 Act.

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B. Benefits of the SHAC Model

1. Access to public capital markets.

2. Securities can be listed on national securities exchanges.

3. Flow-through tax treatment as a partnership.

4. External model permits management fee and incentive fee/waterfall structures similar to traditional private fund structures.

5. Increased transparency from publicly available quarterly financial information.

6. Unlike regulated funds, SHACs are not subject to the limitations on leverage, co-investment or sales of securities below net asset value imposed under the 1940 Act.

C. Other Considerations

1. Federal tax compliance

(a) Must comply with applicable source of income requirements to ensure tax treatment as a partnership.

(b) Income is taxable regardless of distributions being made.

(c) Unlike regulated funds that are RICs, SHACs that are treated as partnerships must deliver K-1s to investors, rather than 1099s.

2. Avoiding 1940 Act regulation

(a) SHACs must generally hold controlling interests in each of their portfolio companies.

(b) Portfolio investments should be based on a “buy and hold” strategy, generally seeking to invest in portfolio companies for cash flow, rather than short-term capital gain, purposes.

3. Public reporting requirements

Subject to periodic reporting requirements with the SEC in the same manner as publicly traded operating companies.

D. SHAC Examples

1. Macquarie Infrastructure Corporation (formerly Macquarie Infrastructure Company LLC) (NYSE: MIC)

2. Compass Diversified Holdings LLC (NYSE: CODI)

3. Fortress Transportation & Infrastructure LLC (NYSE: FTAI)

VII. Special Purpose Acquisition Companies

A. What Is a Special Purpose Acquisition Company?

1. Publicly traded corporation organized to acquire one or more operating companies through a business combination.

2. SPACs issue units consisting of shares of common stock and warrants to raise public funds in an IPO.

3. Subsequent business combination must occur within a set time frame and meet set criteria identified at the time of a SPAC’s IPO:

(a) Percentage of net assets/available capital;

(b) Dollar amount; and

(c) Specific industry designations.

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4. SPAC sponsors typically agree to purchase warrants either at the IPO or through subsequent open market purchases post-IPO.
5. Large percentage of IPO proceeds are held in escrow until stockholders approve a "qualifying" business combination.
6. Proceeds from SPAC sponsors typically fund operating expenses.
7. If successful, SPAC sponsors typically hold a significant percentage (10 to 20 percent) of the post-business combination public company.

B. Benefits of the SPAC Model

1. Access to public capital markets.
2. Securities (units, shares and warrants) can generally be listed on national securities exchanges.
3. SPAC sponsors can obtain significant equity in a publicly traded operating company with relatively low direct outlays of capital.
4. Increased transparency from publicly available quarterly financial information.
5. Unlike regulated funds, SPACs are not subject to the regulatory limitations imposed under the 1940 Act.

C. Other Considerations

1. Difficulty completing a successful business combination
   (a) Approval is typically subject to a "conversion threshold," where a set percentage of stockholders (as low as 19.99 percent) who vote against a transaction and request their capital be returned will cause a transaction not to be approved.
   (b) Hedge funds will often seek to benefit from the difference between market price and cash liquidation value, irrespective of the proposed target company.
   (c) Sponsors often must "give up" a portion of their economics to gain shareholder approval.
2. Limited cash flow pre-business combination
   (a) Until consummation of a business combination, SPACs must generally limit their investments to money market funds and U.S. government securities.
   (b) As a result, SPAC sponsors typically must fund operations prior to completion of a successful business combination.
3. Public reporting requirements
   (a) Subject to periodic reporting requirements with the SEC in the same manner as publicly traded operating companies, even prior to consummation of a business combination.
   (b) SEC staff will closely scrutinize disclosure regarding any proposed business combination.

VIII. Offshore Traded Funds

A. What Are Offshore Traded Funds?

1. Offshore traded funds are generally structured in a manner similar to a closed-end fund, with no investor redemption rights, but seek to avoid the need for registration as an investment company under the 1940 Act by limiting the scope of their investor base.
2. In order to avoid registration under the 1940 Act, offshore traded funds must be formed outside the United States, often in a jurisdiction such as Guernsey, and generally must conduct their initial public offerings in reliance on Regulation S.

3. U.S. investors that qualify as "qualified purchasers" under the 1940 Act, though, can also acquire securities directly from an offshore traded fund in a concurrent Regulation D private placement.
    (a) Permits institutional and high-net-worth individuals to participate in a new offshore fund launch.
    (b) Once the applicable Regulation S holding period has been satisfied, those shares effectively become freely tradable.
4. Investors gain access to liquidity through an exchange listing, often on Euronext or another foreign securities exchange.
5. Pursuant to SEC staff guidance, U.S. persons who acquire shares of an offshore traded fund in the secondary market need not be "qualified purchasers," as long as no nonqualified U.S. purchaser acquires shares directly from the offshore traded fund.
    (a) Generally, offshore traded funds need only focus on the nature of investors in their primary offerings, rather than tracking subsequent open-market purchasers.
    (b) After the Regulation S holding period has expired, an offshore traded fund could develop a relatively broad U.S. shareholder base through normal secondary market trades without requiring registration under the 1940 Act.
6. Often an offshore traded fund will be managed by a U.S. asset manager, alongside similar public and private domestic funds.
7. Offshore traded funds that are treated as PFICs for U.S. federal tax purposes typically agree to provide statements to relevant U.S. investors that would allow such investors to make "qualified electing fund" elections.

    May in certain cases be eligible for mark-to-market tax treatment under the PFIC rules.
8. Offshore traded funds that are treated as partnerships for U.S. federal tax purposes need to meet the qualifying income test or else will likely revert to PFIC tax status.

B. Benefits of the Offshore Traded Fund Model
1. Access to public offshore capital markets.
2. Avoids the need for compliance with the requirements of the 1940 Act applicable to registered closed-end funds.
    (a) No regulatory leverage restrictions.
    (b) No investment restrictions.
    (c) No co-investment restrictions with affiliated private funds.
3. Increased transparency from publicly available financial information, depending on where listed.
4. Public reporting requirements are often less burdensome than for U.S.-listed public funds.

C. Other Considerations
1. Less liquid public market
    (a) Offshore exchanges generally have lower liquidity than U.S. public trading markets, such as NYSE and Nasdaq.
    (b) Limited secondary market liquidity can potentially hurt market price and potentially limit follow-on equity offerings.
2. Limited ability to directly market to U.S. persons

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(a) Offshore traded funds must generally ensure that no public selling efforts occur within the United States.

(b) U.S. direct investors are typically limited solely to "qualified purchasers," making the offshore traded fund more of an institutional vehicle within the United States.

3. Subject to offshore regulatory requirements

(a) Offshore traded funds are subject to periodic reporting requirements depending upon the foreign regulatory and exchange-listing requirements to which the offshore fund is subject.

(b) Depending on jurisdiction, an offshore traded fund may also be subject to registration and ongoing oversight in a manner similar to a U.S. 1940 Act regulated fund.

IX. Real Estate Investment Trusts

A. What Are REITs?

1. Structured in a manner similar to a closed-end fund, but relies on the exception from registration under the 1940 Act under Section 3(c)(5).[11]

2. To comply with Section 3(c)(5), an REIT must generally invest at least 55 percent of its assets in "mortgages and other liens on and interests in real estate."

(a) Remainder of assets must generally consist of investments in "real estate type interests."

(b) Only 20 percent of an REIT's assets may consist of miscellaneous investments.

3. REITs may also comply with the 1940 Act by holding physical real estate in lieu of securities or other interests in real estate.

4. Because REITs fall outside the 1940 Act, they generally have no limit on the use of leverage.

5. Similar to BDCs, REITs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional operating companies.

6. If not publicly traded, REIT public offerings are subject to "blue sky" registration in each state where an offering will be made in the same manner as BDCs.

B. Benefits of the REIT Model

1. Access to public capital markets.

2. Securities can be listed on national securities exchanges.

3. Eligible to elect flow-through tax treatment as a "real estate investment trust" for federal income tax purposes.

4. External model permits management fee and incentive fee structures similar to traditional private fund structures.

5. Increased transparency from publicly available quarterly financial information.

6. No limit on the use of leverage or different classes of equity as with 1940 Act-regulated funds.

C. Other Considerations

1. Federal tax compliance

(a) REITs must meet specific organizational requirements to elect REIT status.

(b) REITs need to comply with applicable asset and source of income requirements.

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[11] *See* Section 3(c)(5) of the 1940 Act.

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(c) Income is generally distributed as earned.

(d) Special rules for non-U.S. investors, depending in part on whether the REIT is publicly traded (ownership of 10 percent or less does not generate FIRPTA gain) or private (FIRPTA applies, other than certain mortgage REITs).

2. Investment restrictions

(a) To avoid registration under the 1940 Act, REITs must generally invest principally in physical real estate, or in mortgages and similar interests in real estate.

(b) Those requirements restrict the use of potentially more attractive unsecured credit instruments in transaction structures.

3. Public reporting requirements

Subject to periodic reporting requirements with the SEC that mirror those applicable to publicly traded operating companies.

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