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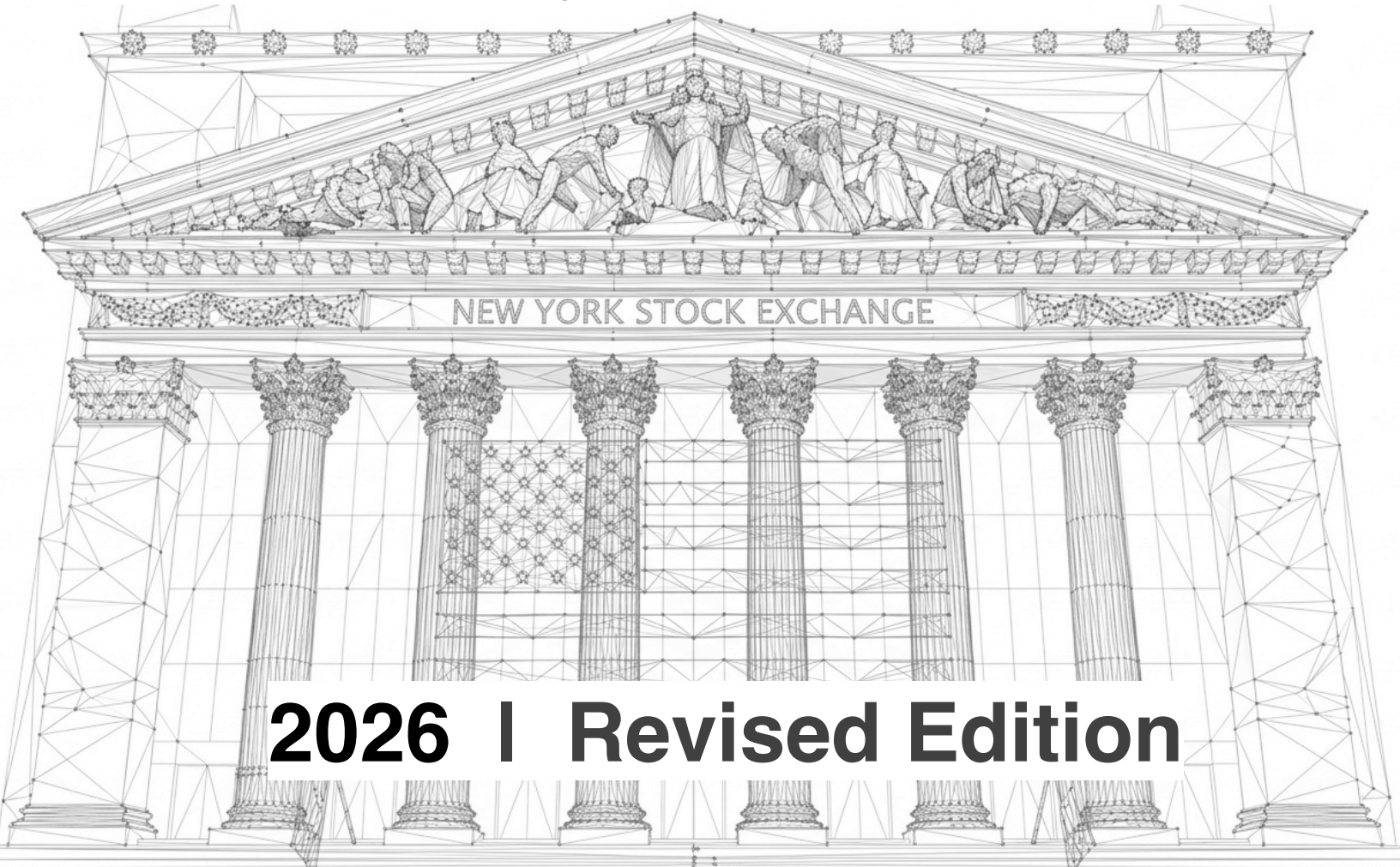


# **U.S. POOLED INVESTMENT COMPANIES**

**COMPREHENSIVE LEGAL GUIDE**

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Corporate Equity | Ownership Mechanics | Regulatory Regimes | Pooled Investments  
Capital Architecture | Multi-Regime Classification | Private Placement and Fund Formation



**2026 | Revised Edition**

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## ABSTRACT

This Guide treats shares of U.S. companies as a single, integrated subject organized in four logical Parts. Part I lays the universal foundation — what a share is as a bundle of rights, the capital statuses (authorized, issued, outstanding, treasury), the class/series architecture under DGCL § 151 and the Model Business Corporation Act, the operational mechanics of certificates of designation and blank-check stock, and the contractual rule of construction that Delaware courts apply to ambiguous share-preference provisions. Part II turns to operational realities: how share ownership is evidenced and recorded on the corporate ledger (with a Delaware/New York comparison), the indirect-holding architecture of the public markets (Cede & Co., the Depository Trust Company, and UCC Article 8 security entitlements), and the creditor-seizure mechanics of UCC § 8-112 across the three holding patterns. Part III addresses regulatory regimes that overlay the universal architecture with specialized definitions — Subchapter S of the Internal Revenue Code and the § 306 preferred-stock bailout, the Securities Act and Exchange Act disclosure framework (Reg S-K Item 202; Rule 12g5-1), and stock-exchange listing standards. Part IV addresses the ultimate particularity: regulation of pooled investment vehicles and corporate funds, with deliberate emphasis on private placement, which is the dominant pathway for the pooled investment structures that constitute most of contemporary U.S. fund practice. Part IV treats the Securities Act and the Howey test, the consequences of registration as an investment company under the 1940 Act (presented for contrast), the §§ 3(c)(1) and 3(c)(7) exclusions, the Regulation D safe harbors under Rules 506(b) and 506(c), and the Investment Advisers Act of 1940 — including the exempt-reporting-adviser exemptions of §§ 203(m) and 203(l), the § 12(g) holder-of-record constraint, and the State blue-sky overlay following NSMIA.

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# PART I

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## PART I — FOUNDATIONS OF U.S. CORPORATE EQUITY AND CAPITAL ARCHITECTURE

This first Part covers the universal, foundational concepts applicable to all U.S. corporate shares, establishing vocabulary, core state-law authority, and the baseline contractual nature of equity. A corporate practitioner asked whether a particular corporation has more than one class of stock will typically respond by asking a clarifying question of her own: more than one class for what purpose? The phrase "class of stock" is a term of art deployed by multiple distinct U.S. legal regimes, each of which uses it to ask a different substantive question and to apply a different operative test. Before any of those regimes can be applied, however, the practitioner must understand what a share actually is as a creature of state corporate law, what statuses it may occupy in the corporation's capital structure, what menu of rights may attach to it, and how courts construe those rights when the operative documents are ambiguous. Part I supplies that foundation.

### Section 1. Fundamental Concepts and Capital Statuses

#### 1.1 The Concept of the Share as a Bundle of Rights

A share of stock in a U.S. corporation is, fundamentally, a creature of contract — specifically, a contract between the corporation and the shareholder that is constituted by the corporation's certificate (or articles) of incorporation, supplemented by board resolutions issued under authority delegated by that certificate, and operating against the background of the corporation's governing state statute. The share itself is not a physical thing, even when represented by a paper certificate; the certificate is merely an evidentiary instrument. What the share represents is a bundle of rights — a collection of legally enforceable entitlements held by the shareholder against the corporation. These entitlements include economic rights (the right to receive dividends if and when declared, the right to share in liquidation proceeds after creditors are paid), governance rights (the right to vote, ordinarily on the election of directors and on extraordinary corporate transactions), and information rights (the right to inspect the corporation's books and records on the conditions specified by statute). The substantive content of each share is determined by reference to the certificate of incorporation.

The most important conceptual point in this entire area is also the one most frequently missed. Whether a corporation has more than one "class of stock" is not a single binary fact about the corporation; it is a question that must be answered separately for each body of law that asks it. A corporation may simultaneously have two classes of stock for state corporate-law purposes (e.g., Class A voting common and Class B nonvoting common, validly created under DGCL § 151) and yet only one class of stock for Subchapter S purposes (because Treas. Reg. § 1.1361-1(l) disregards voting differences). The same corporation may also be required by federal securities law to register and disclose those two interests as two separate classes, and by stock-exchange listing standards to satisfy a third set of class-related constraints. Same shares; four (or more) different classifications. The methodological task in any engagement is to identify which body of law is asking the question and to apply that body's particular test.

#### 1.2 The Capital Status Matrix: Authorized, Issued, Outstanding, Treasury, Reserved

Independent of any classification question, a corporation's capital structure is described by reference to several distinct categories of shares. These categories are not different classes — they are different statuses that any given share, of any class, may occupy at a given moment in time. The Table below summarizes the seven principal statuses.

Concept	Definition	Practical significance
<b>Authorized shares</b>	Maximum number of shares of each class the corporation may issue under its certificate (or articles).	Ceiling, not a count. Increasing it requires charter amendment and shareholder vote (DGCL § 242; MBCA § 10.03).
<b>Issued shares</b>	Shares the corporation has at some point distributed.	Remains issued until formally retired or cancelled, even if reacquired.
<b>Outstanding shares</b>	Issued shares held by persons other than the corporation; outstanding = issued – treasury.	Only outstanding shares vote and receive distributions. Operative count for the Subchapter S test.
<b>Treasury shares</b>	Issued shares reacquired without retirement (DGCL § 160).	Treasury shares neither vote nor receive distributions. MBCA § 6.31 abolishes the category, treating reacquired shares as authorized-but-unissued.
<b>Reserved shares</b>	Authorized but unissued shares set aside for future issuance under options, warrants, conversion of convertibles, or equity-compensation plans.	Board-level commitment, not a statutory status. Matters for capitalization tables and issuance covenants.
<b>Constructively outstanding</b>	Shares deemed outstanding under specific rules — most notably, options, warrants, and convertibles that may constitute a second class under Treas. Reg. § 1.1361-1(l)(4)(iii).	Creature of tax and securities law; not state corporate law. Relevant for S eligibility and SEC beneficial-ownership disclosure (Rule 13d-3).

### 1.3 Fractional Shares, Scrip, and Capital Status Adjustments

Corporate restructurings — stock splits, reverse splits, stock dividends, exchanges in mergers — routinely produce fractional shares. DGCL § 155 authorizes a Delaware corporation to (i) issue fractions of a share, carrying proportional voting and dividend rights; (ii) arrange disposition of fractional interests by those entitled; (iii) pay cash in lieu equal to the fair value of the fractional interest; or (iv) issue scrip in registered or bearer form entitling the holder to a full share upon surrender of an aggregate amount representing one full share. MBCA § 6.04 supplies parallel authority. These tools matter for classification analysis because they directly affect per-shareholder economic and governance arithmetic; the choice between issuing fractional shares with full proportional rights and cashing out fractions in lieu produces different counts of outstanding shares, with downstream consequences under Subchapter S (where disproportionate post-restructuring distributions could create second-class issues), under federal securities law (where holder-of-record counts may shift), and under exchange listing rules (where minimum share-count requirements may apply).

### 1.4 Common Stock and Preferred Stock: The Foundational Categories

Beneath the elaborate menu of class and series characteristics lies a more fundamental binary distinction that organizes the entire field. Every share of a U.S. corporation is, in substance, either common stock or preferred stock. The two categories are defined by reference to each other: preferred stock is any class of stock that has a preference, in respect of one or more material attributes, over another class; common stock is the residual class — the class whose claims to dividends, voting, and liquidation proceeds are subordinated to the preferences of all preferred classes and that absorbs the residual upside (and downside) of the corporation's economic performance. A corporation with only a single class of stock has, by definition, only common stock; the absence of any preferred class means that no class has a preference, and the single class accordingly bears all of the residual character.

Preferred stock derives its name and its operative content from one or more of five economic dimensions on which its claims may be preferred over those of the common: (i) dividend priority — the preferred is entitled to receive dividends, at a stated rate or formula, before any dividend may be paid on the common; (ii) liquidation priority — the preferred is entitled to receive, on dissolution of the corporation, a stated liquidation amount before any liquidating distribution to the common; (iii) redemption rights — the preferred may be redeemed by the corporation at a stated price on stated dates or triggers, or (in the case of put-redeemable preferred) at the holder's option; (iv) conversion rights — the preferred may be converted into common stock at a stated ratio, providing upside participation; and (v) antidilution adjustments — the conversion ratio adjusts upon specified dilutive events, preserving the preferred holder's economic position. Different preferred classes (or series within a class) combine these dimensions in different ways, producing the rich menu of preferred-stock terms encountered in venture-capital, growth-equity, and other private-company financing transactions.

A crucial doctrinal point — taken up in detail in Section 3 below — is that preferred stock is preferred only in the specifically enumerated ways set forth in the certificate of incorporation or in a board resolution issued under blank-check authority. The preferred holder has no general right to be "preferred" beyond those specific contractual entitlements; in all other respects, the preferred holder is in the same position as a common holder. This means, for example, that absent an express dividend-priority provision, the preferred holder has no priority on dividends; absent an express liquidation preference, the preferred holder has no liquidation priority; and absent an express conversion right, the preferred holder cannot convert into common. Each preference is a contractual term that must be plainly stated, and ambiguities in the operative documents are construed against the preferred holder under the rule of *Rothschild International Corp. v. Liggett Group Inc.*, 474 A.2d 133 (Del. 1984), examined at length in Section 3.1 below.

The state-statutory framework that permits the creation of preferred stock is, in Delaware, DGCL § 151(a), which authorizes the issuance of "1 or more classes of stock or 1 or more series of stock within any class thereof," with each class or series potentially having different "voting powers, full or limited, or no voting powers, and . . . such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions" as the certificate of incorporation or the board resolution specifies. The use of the disjunctive "or" throughout the statute is deliberate: each economic attribute may be set independently of any other, and the combinations are limited only by the drafter's imagination and the rule against creating shares that are not stock — that is, instruments that lack any of the residual characteristics of equity (e.g., a perpetual fixed-rate obligation with no voting, no equity upside, and no participation in liquidation proceeds in excess of par may, under appropriate circumstances, be recharacterized as debt for state-law as well as tax-law purposes).

## **Section 2. The Structural Menu: Classes and Series of Stock**

## **2.1 The Class/Series Distinction Under State Law (DGCL § 151 and MBCA §§ 6.01–6.02)**

Delaware General Corporation Law § 151(a) authorizes a corporation to issue "1 or more classes of stock or 1 or more series of stock within any class thereof," each potentially having "such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions" as set forth in the certificate of incorporation or in a board resolution issued under authority granted by the certificate. Three structural points are critical. First, classes and series are not parallel categories; series exist within a class. Second, classes ordinarily must be created (and their terms set) by the certificate of incorporation; series can be created by a board resolution under blank-check authority. Third, § 151(f) requires that the powers, designations, preferences, and special rights of each class and each series be summarized on the share certificate or, alternatively, that the certificate state that the corporation will furnish them upon request without charge.

The Model Business Corporation Act, the basis of corporate codes in 36 or more jurisdictions, employs a closely parallel architecture. MBCA § 6.01 governs authorized shares; MBCA § 6.02 permits the board, when authorized by the articles, to determine the terms of series within a class and to allocate authorized but unissued shares from one class or series to another without shareholder approval. The two regimes are substantively equivalent for present purposes; the operational implementation differs in detail but not in concept.

## **2.2 Operational Mechanics: Blank-Check Stock and Certificates of Designation**

Under DGCL § 151(g), a Delaware corporation creating a series of stock pursuant to authority delegated by its certificate of incorporation must file a Certificate of Designation with the Delaware Secretary of State. The Certificate of Designation sets forth the board resolutions establishing the series, the number of shares constituting the series, and all powers, designations, preferences, rights, and qualifications that the board has fixed within the scope of the delegated authority. Once filed, it operates as an effective amendment to the corporation's Certificate of Incorporation. No shareholder approval is required — the certificate of incorporation, by its original terms, pre-authorizes the board to alter the certificate itself within the parameters of the delegation, and the resulting board resolution has the force of a charter amendment.

The standard drafting approach in a venture-backed company's original certificate is to authorize a large pool of "blank-check" preferred stock — typically several million shares of undesignated preferred — that the board may later designate into series with terms set at the time of issuance. This architecture allows the corporation to raise successive financing rounds, each with its own series-level preferred terms, without returning to the shareholders for charter amendments on each round. The original-issuance shareholders, in approving the certificate of incorporation, consent in advance to the board's exercise of that delegated authority.

## **2.3 The Rights Menu: Dividend, Voting, Liquidation, Conversion, and Redemption Variances**

The substantive content of any share interest is defined by reference to a closed set of characteristics. These characteristics are the same regardless of whether they are used to create a class or a series; the underlying menu of rights is identical. What differs is the mechanism of creation — class by certificate of incorporation, series by board resolution under blank-check authority. The Table below summarizes the principal characteristics and the level (class or series) at which each is typically established.

Characteristic	What it controls	Typically fixed at level of
<b>Common vs. preferred designation</b>	Fundamental categorical distinction: residual equity (common) vs. preferential claim (preferred).	CLASS only. Always created by the certificate.
<b>Voting power (general)</b>	Whether shares vote at all; if so, how many votes per share and on what matters.	Typically CLASS (voting vs. nonvoting common); can be set at series level.
<b>Class-vote / protective provisions</b>	Matters on which a class or series may vote separately (charter amendments adverse to the class; issuance of senior stock; mergers).	EITHER — frequently set at series level in venture-financed companies.
<b>Par value / no-par status</b>	Whether shares have par value; affects capital accounts and franchise tax.	CLASS. Series within a class share the par value.
<b>Dividend rate or formula</b>	Specific rate; cumulative or noncumulative; participating or nonparticipating.	Typically SERIES, especially in successive financing rounds.
<b>Liquidation preference amount</b>	Specific dollar amount payable on dissolution before junior classes.	Typically SERIES. Preference itself distinguishes preferred from common; amount distinguishes series.
<b>Conversion ratio and antidilution</b>	Ratio at which preferred converts into common; antidilution adjustments.	Typically SERIES. Each round has its own conversion price.
<b>Redemption price and triggers</b>	Whether shares are redeemable, at whose option, when, and at what price.	Typically SERIES, fixed by the certificate of designation.
<b>Issue date and OIP terms</b>	Date series was created and original issue price; reference for many other terms.	SERIES only. Each series corresponds to a discrete issuance event.

## 2.4 Series Recycling: Retirement and Elimination Mechanics

DGCL § 151(g) supplies a counterpart mechanism for eliminating series. If all shares of a particular series are redeemed, retired, or reacquired, and no shares of the series remain outstanding, the board may file a certificate eliminating the series. The shares originally designated to that series return to the pool of undesignated preferred stock and become available for redesignation as a new series on different terms. This recycling capability is important in venture-financed companies where successive financing rounds may make earlier-series designations obsolete: after a Series A is fully converted in an IPO, the underlying authorized shares may be redesignated for use in future preferred issuances. The mechanism is simple in concept but easily forgotten in practice; outdated obsolete series carried on the certificate of incorporation as theoretical possibilities create unnecessary cap-table confusion and occasional documentary surprises in M&A due diligence.

## Section 3. Judicial Interpretation and Construction of Share Rights

Even after the substantive rights of a class or series have been catalogued in the certificate of incorporation or a certificate of designation, ambiguities in the operative documents routinely arise. When they do, courts — particularly Delaware courts construing the certificates of Delaware corporations — apply a robust body of

doctrine concerning the construction of share-preference provisions. The doctrine has two central pillars: strict construction of preferences as a creature of contract, and a default presumption of commonality (residual-equity treatment) that resolves ambiguities against preferred holders claiming priority.

### 3.1 The Contractual Rule: Strict Construction of Preferred Share Preferences

Delaware courts have long held that the rights of preferred stockholders are largely contractual rather than equitable. The leading line of cases — *Rothschild International Corp. v. Liggett Group Inc.*, 474 A.2d 133 (Del. 1984); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584 (Del. Ch. 1986); and the more recent *In re Trados Inc. Shareholder Litigation* decisions of the Court of Chancery — establish that preferred holders look first to the express terms of their preferences as set forth in the certificate of designation. Unless a preference is clearly stated, it does not exist. The certificate is treated as a contract; conventional contract-construction principles apply. The Delaware Supreme Court's formulation in *Rothschild* is widely quoted: preferences "are not to be implied; they must be plainly expressed."

A drafting failure produces a real, enforceable loss for the preferred holder. If the certificate of designation does not clearly grant a participating-preferred right of further participation in residual liquidation proceeds, the preferred holder receives only its stated liquidation preference and no further participation. If the certificate does not specify that dividends are cumulative, they are noncumulative, and accrued-but-unpaid dividends are lost on each non-declaration cycle. If a protective-vote provision lists specific enumerated triggers but is silent on a particular contemplated corporate action, no protective vote attaches to that action.

### 3.2 The Presumption of Commonality: Resolving Charter Ambiguities Against Preferred Priorities

The corollary doctrine — sometimes called the "presumption of commonality" — holds that ambiguities in the certificate are resolved against preferences and in favor of common-stock-like treatment. The default character of any share is to be a common share, with full residual participation and no priority. Any deviation must be clearly expressed and is construed narrowly. Three operative implications follow: the burden of clarity rests on counsel for the preferred holders; courts will not imply preferences from commercial context or apparent expectations; and in litigation between preferred and common holders, preferred holders bear the practical burden of identifying the textual hook for any claimed right. The doctrine has cross-cutting implications for the classification analyses developed in Part III of this Guide, since ambiguously drafted "preferred" provisions may, in substance, fail to constitute a second class for Subchapter S purposes, leaving the corporation with what is in form two classes but what is in substance, under contract-construction principles, a single class.

### 3.3 Practical Consequences and Drafting Lessons

The contractual rule of Section 3.1 and the commonality presumption of Section 3.2 produce concrete drafting lessons that practitioners ignore at their peril. Each is the trace of a litigation outcome in which a preferred holder, having relied on commercial understandings or apparent expectations not reduced to express text, lost a contested distribution, vote, or veto. The following are the principal recurring drafting failures.

- **Cumulative dividends.** If a certificate of designation does not affirmatively state that dividends accrue and cumulate from year to year (whether or not declared), they are noncumulative. A preferred holder relying on accumulated unpaid dividends as a claim against the corporation will be told that, in the absence of express cumulation language, the unpaid dividends are simply lost on each fiscal year in which the board declines to declare them. The drafting fix is a single sentence: "Dividends on the Series A

Preferred shall accrue and shall be cumulative from the date of original issuance, whether or not earned or declared."

- **Participating preferred.** A "participating" preferred is one that, after receiving its stated liquidation preference, continues to share with the common in the distribution of remaining liquidation proceeds. A "non-participating" preferred receives only its preference. Charters that establish a preferred class without expressly stating participation will be construed as non-participating; the preferred holder, having received the stated \$X liquidation preference, will have no further claim on the residual. Where participation is intended, the certificate must say so: "After payment in full of the Series A Liquidation Preference, the Series A Preferred shall participate with the Common Stock on a Common-equivalent basis in any remaining liquidation proceeds."
- **Protective-vote scope.** Protective provisions list specific corporate actions that require the consent of the preferred (or a specified percentage of the preferred). The list is closed: actions not enumerated do not trigger a class vote, even if the action is functionally equivalent to one that is enumerated. A list reading "the Corporation may not (i) amend its certificate of incorporation in a manner adverse to the Series A Preferred, (ii) authorize a senior or pari passu series of preferred stock, or (iii) consummate a Deemed Liquidation Event" does not give the Series A a vote on a recapitalization that does not technically amend the certificate but achieves the same economic result through a holding-company merger. The drafting fix is to enumerate the protective triggers broadly enough to cover functional equivalents, and to include catch-all language: "any action that has the effect of any of the foregoing."
- **Liquidation preference scope and Deemed Liquidation Events.** The certificate must address whether mergers, sales of substantially all assets, and similar change-of-control transactions are deemed to be liquidations triggering the preference. Standard practice is to define a "Deemed Liquidation Event" and to specify that the preference applies to such events as well as to formal dissolution. Failure to do so leaves the preferred holder at risk of receiving the merger consideration on a pro-rata as-converted basis, without first receiving the preference.
- **Antidilution mechanics.** Conversion-ratio antidilution adjustments — the mechanism by which a preferred holder's conversion price is reduced upon issuance of additional stock at a price below the preferred's conversion price — must be drafted with precision. Different formulas (full ratchet, narrow-based weighted average, broad-based weighted average) produce materially different outcomes in a dilutive financing. The certificate should specify the formula in full, identify excluded issuances (e.g., shares issued under employee equity plans, shares issued in connection with strategic transactions), and address the interaction with stock splits, stock dividends, and reverse splits.

The cross-cutting implication is that careful charter drafting at the time of original issuance is materially more valuable than litigation skill at the time of dispute. The Delaware courts will enforce the certificate as written; they will not rewrite it to reflect what the parties "must have" intended. The transactional lawyer's principal contribution to the preferred holder's economic outcome occurs in the drafting room, not the courtroom.

## PART II

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### **PART II — OPERATIONAL REALITIES: OWNERSHIP EVIDENCE, TRANSFER, AND CREDITOR MECHANICS**

Moving from abstract corporate creation to physical and digital operations, this Part addresses how share ownership is documented, tracked, transferred, and involuntarily taken or enforced under commercial law. The substantive rights catalogued in Part I are operationally useless without an evidentiary apparatus that proves who owns the shares, what those shares confer, and how transfers and other transactions are to be recorded. That apparatus is the corporate stock ledger (or, in modern terminology, the record of shareholders), supplemented by either physical share certificates or — increasingly — by uncertificated book entries, and overlaid in the public-market context by the indirect-holding architecture of the Depository Trust Company. Each of these layers carries its own commercial-law consequences, most importantly for the question how a judgment creditor of a shareholder reaches the debtor's interest in the shares.

#### **Section 4. Evidence of Ownership and Stock Ledger Maintenance**

##### **4.1 Certificated vs. Uncertificated Shares: The Practical Elimination of Paper**

Historically, every share of stock was represented by a physical certificate — an engraved or printed document that could be physically delivered, endorsed in blank, and pledged as collateral. DGCL § 158 originally required certificate issuance for every share. Since legislative amendments beginning in 1983, DGCL § 158 has expressly permitted the issuance of "uncertificated shares" — shares represented only by entries on the corporation's books and records, with no paper instrument. NY BCL § 508 took a parallel modernizing path. Today, the vast majority of newly issued shares — certainly in venture-backed private companies and increasingly even in public-company practice — are uncertificated. The shift reflects three drivers: elimination of physical custody risk (lost or destroyed certificates require expensive bond-and-affidavit replacement procedures); easier enforcement of transfer restrictions (no paper to traffic in); and substantial administrative-cost reduction (no engraving, printing, signing, or mailing of certificates).

##### **4.2 State-by-State Ledger Requirements: Delaware (DGCL § 224) vs. New York (NY BCL § 624(a))**

DGCL § 224, as amended in 2017 and further refined by 2024 amendments, provides a highly flexible, technology-forward standard. The provision authorizes any records maintained by a corporation — including its stock ledger — to be kept on or by means of "any information storage device, method, or 1 or more electronic networks or databases (including 1 or more distributed electronic networks or databases)," provided the records can be converted into clearly legible paper form within a reasonable time. The express reference to distributed networks accommodates blockchain-based and other cryptographic ledger systems.

NY BCL § 624(a) requires every corporation to maintain "a record containing the names and addresses of all shareholders, the number and class of shares held by each and the dates when they respectively became the owners of record," and allows these records to be kept in written form "or in any other form capable of being

converted into written form within a reasonable time." The statutory text is older than DGCL § 224 and lacks the explicit reference to blockchain or distributed-ledger systems. The text plainly accommodates electronic record-keeping in the abstract — any form capable of being converted to written form satisfies the rule — but New York corporations contemplating tokenized share registries operate under thinner statutory cover than their Delaware counterparts.

Beyond format, the two statutes diverge on geography. Under DGCL § 219, a Delaware corporation is not required to keep its stock ledger within the State of Delaware. The ledger may be maintained at the corporation's principal place of business (rarely Delaware), at the office of its transfer agent (regardless of state), or in the cloud. NY BCL § 624(a) is materially different: the text explicitly mandates that the record of shareholders must be kept "at the office of the corporation in this state or at the office of its transfer agent or registrar in this state." This creates an in-state physical-presence requirement that has no equivalent under the DGCL. A New York corporation cannot satisfy § 624(a) by maintaining its ledger exclusively at an out-of-state principal place of business or at an out-of-state transfer agent.

### **4.3 Evidentiary Weight: "Sole Evidence" (Delaware) vs. "Prima Facie" Rebuttable Status (New York)**

DGCL § 219(c) provides that the stock ledger "shall be the only evidence as to who are the stockholders entitled to examine the stock ledger, the list required by this section or the books of the corporation, or to vote in person or by proxy at any meeting of stockholders." Delaware courts treat the ledger as a conclusive administrative bright line. If your name is not on the ledger, the corporation is not required to recognize you as a stockholder for voting, inspection, or notice purposes; the aggrieved party's recourse is to seek an equitable order requiring the corporation to amend the ledger, typically through a DGCL § 225 or § 227 proceeding.

NY BCL § 607 similarly states that the list of shareholders prepared for the meeting is prima facie evidence of who is entitled to vote. The word choice is deliberately weaker than Delaware's "only evidence." New York courts historically show greater willingness to look past a missing or inaccurate ledger to find that a person achieved shareholder status through a binding contract, payment of consideration, or other operative facts, even where the corporate officers failed to update the ledger. The substantive distinction matters most in close-corporation disputes, where ledger maintenance may be informal or contested.

### **4.4 Mandatory Post-Issuance Shareholder Notices (DGCL § 151(f) and NY BCL § 508(f))**

Because uncertificated stock lacks a physical medium on which to display the statutory disclosures historically required on the face of a stock certificate, both states mandate that specific notices be sent in writing to the registered holder. DGCL § 151(f) provides that, within a reasonable time after the issuance or transfer of uncertificated shares, the corporation must send the shareholder a written notice containing all the information that would otherwise be required to appear on a physical certificate — most notably, a full statement or summary of the powers, designations, preferences, and relative, participating, optional, or other special rights of each class of stock or series. NY BCL § 508(f) mirrors this in substance but is more explicit in articulating the request-and-furnish alternative, explicitly requiring that the statement note the corporation will furnish, without charge, a full statement of the designations and rights upon shareholder request.

## **Section 5. Public Market Infrastructure and the Indirect Holding System**

### **5.1 The Multilayered Reality: Cede & Co., DTC, and Street-Name Brokerage Accounts**

For publicly traded shares, the operational reality diverges sharply from the close-corporation model. Almost all publicly traded U.S. shares are held through the Depository Trust Company (DTC), a centralized securities depository organized under New York law and regulated by the SEC, the New York State Department of Financial Services, and the Federal Reserve System. The mechanics, in simplified form, are as follows. The issuer's transfer agent registers a single large block of shares on the corporation's books in the name of DTC's nominee, Cede & Co. DTC, in turn, holds positions on its own books in the names of its participants — primarily broker-dealers, banks, and trust companies. The participants, in turn, hold positions on their own books in the names of their customers, who may be the ultimate beneficial owners or themselves intermediaries (a brokerage account holding for an investment-management client, for example).

The result, as a matter of stock-ledger doctrine, is striking: the issuer's ledger shows a single record holder — Cede & Co. — regardless of how many beneficial owners hold positions in the issuer's shares. A NYSE-listed company with millions of beneficial owners may have only a handful of record holders on its books, the great majority of whom are Cede & Co. or other depository nominees. This indirect-holding architecture has profound consequences for the held-of-record analysis under Rule 12g5-1 (addressed in Section 8.2 below) and for the operative creditor-seizure mechanics under UCC § 8-112 (addressed in Section 6 below).

## **5.2 The UCC Article 8 Framework: Security Entitlements vs. Direct Property Rights**

Article 8 of the Uniform Commercial Code, comprehensively revised in 1994 and adopted in substantially uniform form in every U.S. jurisdiction, supplies the legal framework for the indirect-holding system. The framework distinguishes among three categories of investor:

- the holder of a certificated security (UCC § 8-102(a)(4)), who owns a tangible certificate representing the security itself;
- the registered owner of an uncertificated security (UCC § 8-102(a)(18)), whose name is on the issuer's books as a direct holder; and
- the entitlement holder (UCC § 8-102(a)(7)), who holds a "security entitlement" against a securities intermediary (UCC § 8-501) that has, in turn, a position with the next tier up the chain.

The third category — the security entitlement — is the operative legal status of the vast majority of public-company beneficial owners. The customer of a broker-dealer holding shares of a NYSE-listed company does not, technically, own the shares; the customer holds a security entitlement against the broker-dealer, which holds a position with DTC, which is the record holder of the underlying shares through its nominee Cede & Co. The security entitlement carries all the economic and governance attributes of share ownership (dividends, voting through pass-through procedures, capital appreciation), but it is, as a matter of property law, a different kind of asset from a directly held share. The distinction matters enormously for the rules governing creditor seizure under UCC § 8-112, examined in detail in Section 6 below.

## **5.3 Settlement Mechanics, Securities Lending, and Customer-Property Protection**

The operational backbone of the indirect-holding system is the clearance and settlement infrastructure operated by DTC and its affiliates. Securities trades executed on a U.S. national securities exchange or over-the-counter market are cleared through the National Securities Clearing Corporation (NSCC), which acts as central counterparty, novating each side of every trade so that buyer and seller each face only NSCC. Settlement — the actual transfer of securities and cash — occurs through DTC on a delivery-versus-payment (DVP) basis: the buyer's cash is transferred to the seller, and the seller's securities position is transferred to the buyer, only simultaneously and only through the DTC book-entry system. The standard U.S. settlement

cycle was shortened from T+3 to T+2 in 2017 and further to T+1 in May 2024, meaning that securities settle one business day after trade date. Trades effected on day T are firm contractual obligations; failure to deliver on T+1 results in fail-to-deliver penalties and, in extreme cases, mandatory buy-ins under SEC Rule 204 of Regulation SHO.

Securities lending — the practice by which a holder of securities loans them to a borrower (typically a broker-dealer or hedge fund) in exchange for cash collateral and a stated rebate rate — operates within the same UCC Article 8 framework. A securities loan is, doctrinally, a transfer of ownership: the lender becomes the holder of cash collateral, and the borrower becomes the holder of the securities. The borrower may rehypothecate the borrowed securities to its own customers or use them to cover short positions. The lender's economic position is preserved through the borrower's contractual obligation to deliver equivalent securities back upon termination of the loan, together with manufactured payments equal to any dividends, interest, or other distributions paid on the borrowed securities during the loan period.

The customer-property regime under SEC Rule 15c3-3 (the "Customer Protection Rule") and the Securities Investor Protection Act of 1970 (SIPA) supplies a layer of protection for the customers of broker-dealers in the event of broker-dealer failure. Rule 15c3-3 requires broker-dealers to segregate customer securities and to maintain a reserve formula computation ensuring that the broker-dealer holds, on a daily basis, sufficient assets to cover its net obligations to customers. In a broker-dealer liquidation under SIPA, the Securities Investor Protection Corporation (SIPC) advances funds to satisfy customer claims up to specified limits (\$500,000 per customer, with a \$250,000 cash subcomponent). The Lehman Brothers Inc. SIPA liquidation that followed the September 2008 bankruptcy of Lehman Brothers Holdings Inc. tested the customer-property regime at unprecedented scale and demonstrated both the strengths (orderly transfer of customer accounts to acquiring brokers) and the operational complexities (multi-year disputes over the proper allocation of cash and security positions) of the framework. For purposes of this Guide, the principal point is that the security entitlement held against a broker-dealer is a contractual claim, but it is a claim backed by a segregation regime and an insurance program that materially distinguish it from an ordinary unsecured creditor's claim.

## **Section 6. Creditor Seizure, Judicial Attachment, and Forced Enforcement**

Shares of stock are property and, as such, are reachable by creditors of the shareholder. The operative rules governing creditor attachment and execution against securities are supplied not by state corporate law — which is silent on the procedural mechanics of creditor seizure — but by Article 8 of the Uniform Commercial Code, in particular UCC § 8-112, supplemented by the procedural rules of the jurisdiction in which the creditor is enforcing the judgment. The mechanics differ materially depending on whether the shares are certificated, uncertificated and held directly, or held indirectly through a securities intermediary as a security entitlement.

### **6.1 Jurisdictional and Control Rules Under UCC § 8-112**

UCC § 8-112 prescribes how a judgment creditor may reach the debtor's interest in securities. The provision divides the operative rules into three subsections corresponding to the three principal forms in which a debtor may hold securities: certificated securities (subsection (a)), uncertificated securities held directly with the issuer (subsection (b)), and securities held indirectly through a securities intermediary as a security entitlement (subsection (c)). The conceptual framework is one of "control" over the security; for each holding pattern, § 8-112 identifies the person or entity that controls the relevant interest and directs creditor process to that person.

## 6.2 Execution Mechanics by Holding Type

### *(i) Physical Seizure of Certificated Shares — UCC § 8-112(a)*

Under UCC § 8-112(a), "the interest of a debtor in a certificated security may be reached by a creditor only by actual seizure of the security certificate by the officer making the attachment or levy, except as otherwise provided in subsection (d)." In operational terms: the sheriff must physically take possession of the paper certificate representing the shares. The default rule for certificated securities is physical custody: no certificate, no levy. The rule produces administrative difficulty in modern practice because so few shares are certificated, but it remains operative when a debtor does hold paper certificates, most commonly in old, closely held corporations where the original issuances were certificated and have never been converted to book-entry form.

### *(ii) Service of Process on Issuer for Direct Uncertificated Shares — UCC § 8-112(b)*

Under UCC § 8-112(b), "the interest of a debtor in an uncertificated security may be reached by a creditor only by legal process upon the issuer at its chief executive office in the United States to effect the attachment." Where the debtor holds shares directly with the issuer (as opposed to through a brokerage intermediary), the creditor's writ is served on the issuer's chief executive office. The issuer, on receiving service, must refuse any further transfer of the debtor's shares pending resolution of the creditor's claim. Direct uncertificated holding is most commonly seen in private companies where shares are issued in book-entry form on the corporation's own ledger, and in certain public-company holdings registered through DTC's Direct Registration System (DRS), under which the beneficial owner appears directly on the issuer's books rather than through Cede & Co.

### *(iii) Garnishment of the Securities Intermediary — UCC § 8-112(c)*

Under UCC § 8-112(c), "the interest of a debtor in a security entitlement may be reached by a creditor only by legal process upon the securities intermediary with whom the debtor's securities account is maintained." Where the debtor holds shares as a security entitlement against a broker-dealer, bank, or other intermediary — which describes the vast majority of public-company holdings — the creditor's writ is served on the intermediary, not on the issuer. The intermediary, on receiving service, must freeze the debtor's account and may not honor transfer or withdrawal instructions inconsistent with the creditor's interest.

## 6.3 Judicial Sales, Auctions, and Forced Corporate Ledger Updates

Attachment of the debtor's interest under one of the three mechanisms above does not, by itself, transfer ownership; it freezes the interest pending execution. The execution typically proceeds by judicial sale — most commonly a public auction conducted by the sheriff or marshal. The proceeds, net of execution costs, are applied to the judgment. For shares held through an intermediary, the court may alternatively issue a turnover order directing the intermediary to liquidate the position and transfer the proceeds to the creditor or a court-appointed receiver. Following the sale, the purchaser presents the operative documents to the corporation or intermediary, which then records the transfer on its books. For close corporations, judicial sale of shares to a stranger can produce profoundly awkward operational results.

## 6.4 Close-Corporation Roadblocks: Transfer Restrictions, Buy-Sell Agreements, and Rights of First Refusal

Most close corporations protect themselves against unwanted shareholder turnover by including contractual or charter-based transfer restrictions: rights of first refusal, rights of first offer, buy-sell agreements mandating purchase at a formula price on specified events, and outright prohibitions on transfer absent corporate

consent. These restrictions are generally enforceable provided they meet the validity requirements of DGCL § 202 (governing transfer restrictions on Delaware corporation stock) or corresponding provisions of other state codes. Critically, transfer restrictions generally bind any transferee, including a transferee who acquires the shares through judicial process. The judicial purchaser takes the shares subject to the restrictions, not free of them. The practical consequence is that the purchaser at a judicial sale of close-corporation stock often cannot freely re-sell on the open market; she must instead offer the shares to the corporation or to existing shareholders at the contractually specified price. This dramatically reduces the practical value of the seized stock, and is the principal reason that judgment creditors of close-corporation shareholders often pursue alternative remedies, such as a charging order against distributions, rather than execution on the shares themselves.

### **6.5 Charging Orders as the Alternative Remedy for Equity Interests in LPs and LLCs**

Although the UCC Article 8 mechanics of Sections 6.1 through 6.3 are addressed specifically to securities — including corporate stock and many limited partnership interests — they do not extend to the equity interests in entities that issue interests not constituting securities, principally member-managed LLCs and general partnerships whose members or partners actively manage the business. For these holders, the operative creditor remedy is the charging order — a creature of state limited-liability-entity statutes rather than of UCC Article 8 — that gives a judgment creditor a lien on the distributions payable to the debtor-member or debtor-partner without conferring on the creditor any of the debtor's governance rights or any interest in the entity itself.

The Delaware Limited Liability Company Act § 18-703 and the Delaware Revised Uniform Limited Partnership Act § 17-703 each provide that a judgment creditor may obtain a charging order against the debtor's membership or partnership interest, that the charging order constitutes a lien on the debtor's distributions, and that the charging order is the exclusive remedy by which a creditor may satisfy a judgment out of the debtor's interest in the entity. The exclusivity provision is the most consequential element: even where the debtor's distributions are nil and the creditor's charging order produces no recovery, the creditor cannot reach the underlying interest itself. The creditor cannot force a sale of the membership interest, cannot vote the interest, cannot inspect the entity's books, and cannot compel a distribution. The creditor's remedy is limited to whatever distributions the entity, in its discretion, chooses to make.

The charging-order exclusivity rule produces a significant asset-protection advantage for equity holders in LLCs and LPs, particularly when the entity has multiple members and the managers control distribution timing. The advantage is qualified, however, in the single-member-LLC context. The Florida Supreme Court in *Olmstead v. FTC*, 44 So. 3d 76 (Fla. 2010), held that the charging-order exclusivity rule of the Florida LLC Act did not apply to a single-member LLC, on the theory that the policy rationale for exclusivity — protection of innocent non-debtor co-members from creditor interference in entity operations — has no force where there are no co-members to protect. The *Olmstead* reasoning has been followed by some courts and rejected by others; the question turns on the specific statutory text of the operative state's LLC act, and a number of states (including Delaware, in 2013 amendments to DLLCA § 18-703) have responded to *Olmstead* by expressly extending charging-order exclusivity to single-member LLCs. The practitioner advising on entity selection for asset-protection purposes must consult the operative state-law charging-order regime and the relevant case law.

For purposes of this Guide's principal subject — shares of U.S. corporations — the charging-order regime is largely inapplicable, because corporate stock is a security reachable through UCC § 8-112. The charging order is relevant principally to the GP, the management company, and the sponsor holdco at the upper levels of a

private fund structure, where those entities are organized as LLCs (or, in the case of the fund itself, as an LP with the manager-GP being an LLC). The creditor of a fund sponsor seeking to reach the sponsor's economic interest in the fund's general partner faces the charging-order regime, not UCC § 8-112; the creditor of a public-company shareholder seeking to reach the shareholder's shares faces UCC § 8-112, not the charging-order regime. The distinction matters operationally and is occasionally a basis for sophisticated estate-planning structures.

## PART III

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### PART III — REGULATORY REGIMES AND MULTI-REGIME CLASSIFICATION TRAPS

Moving from general operations into particularities, this Part addresses how various specialized regulatory bodies — Tax, Securities, and Exchanges — overlay their own independent definitions of "shares," "classes," and "holders" onto the underlying corporate asset. Each regime asks a different substantive question, applies a different operative test, and may reach a different conclusion about the same shares. The integrated treatment of these regimes is the subject of this Part. The further particularization that applies when corporate shares are issued by, or purchased by, pooled investment vehicles is the subject of Part IV.

#### Section 7. Federal Tax Law Classifications

##### 7.1 Subchapter S Pass-Through Policing: The "Identical Economic Rights" Test

Internal Revenue Code § 1361(b)(1)(D) provides that an eligible S corporation may not have more than one class of stock. The Treasury Regulations under § 1.1361-1(l) supply a definition of "class" substantially narrower than the corporate-law concept. The core operative rule, set out in Treas. Reg. § 1.1361-1(l)(1): subject to the anti-abuse rules in subparagraph (l)(4), a corporation is treated as having only one class of stock if all outstanding shares confer identical rights to distribution and liquidation proceeds. Differences in voting rights are explicitly disregarded. Of the characteristics catalogued in Section 2.3 of this Guide, only two matter for Subchapter S: distribution rights and liquidation rights.

Treas. Reg. § 1.1361-1(l)(2)(i) prescribes the sources to be consulted: the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds — collectively, the "governing provisions." An ordinary commercial contract is not a binding agreement unless a principal purpose of the contract is to circumvent the one-class requirement. The principal-purpose qualification applies only to contractual arrangements, not to the corporate charter, articles, bylaws, or state law, all of which can create a second class regardless of purpose. Because voting differences are explicitly disregarded, an S corporation may have voting and nonvoting common stock outstanding simultaneously, classes that vote only on certain matters, irrevocable proxy arrangements, and groups of shares differing only with respect to the right to elect particular board members.

##### 7.2 The S-Corp Safe Harbor for Close-Corporation Buy-Sell and Redemption Agreements

Treas. Reg. § 1.1361-1(l)(2)(iii) supplies a robust safe harbor designed to immunize close-corporation buy-sell and redemption arrangements from the one-class analysis. Under the safe harbor, buy-sell, redemption, and transfer-restriction agreements are disregarded unless both of the following are present: (i) a principal purpose of the agreement is to circumvent the one-class-of-stock requirement; and (ii) the agreement establishes a purchase price that, at the time of the agreement, is significantly in excess of or significantly below the fair market value of the stock. The conjunctive structure is critical: agreements pricing at book value, or at a price

between book value and FMV, are deemed not to establish a price significantly off FMV. This deemed-not-to-deviate rule effectively immunizes the vast majority of conventional close-corporation buy-sell formulas.

Treas. Reg. § 1.1361-1(l)(4) addresses arrangements that may be recharacterized as a second class. Certain debt instruments are recharacterized as equity; § 1.1361-1(l)(5) provides a "straight debt" safe harbor for genuine indebtedness meeting specified criteria. Deferred-compensation arrangements, restricted stock, stock options, and similar instruments are subject to detailed rules in § 1.1361-1(l)(4)(iii). Disproportionate actual distributions are evidence either of a circumventing binding agreement or, more commonly, of inadvertent disproportionate distributions curable through inadvertent-termination relief under § 1362(f).

### **7.3 The C-Corporation Shadow: The § 306 "Preferred Stock Bailout" Anti-Abuse Trap**

Subchapter S forbids multi-class structures entirely; a C corporation may freely employ them. But a C corporation utilizing multiple classes must reckon with I.R.C. § 306, the "preferred stock bailout" rule. Section 306 arose from a mid-twentieth-century tax-arbitrage technique: a corporation would distribute a nontaxable preferred stock dividend to its common shareholders, who would then sell the preferred to a third party, extracting cash at capital-gain rates without the dividend treatment an outright cash distribution would have triggered. Section 306 defines "section 306 stock" to include preferred received by a shareholder as a nontaxable stock dividend on common. When § 306 stock is sold to a third party, the proceeds — up to the stock's ratable share of E&P at distribution — are recharacterized as ordinary dividend income. When § 306 stock is redeemed, the entire proceeds are generally treated as a § 301 distribution. Exceptions are available — complete termination of interest under § 302(b)(3), complete liquidation under § 331, dispositions establishing absence of tax-avoidance principal purpose under § 306(b)(4) — but each requires advance planning and adequate documentation.

## **Section 8. Federal Securities Law Classifications**

Federal securities law does not impose substantive limits on the classes a corporation may create; that remains a matter of state corporate law. Federal law instead requires that each class be disclosed and described accurately for the protection of investors. This Section addresses the classification dimension — how federal securities law treats different share types for disclosure and registration-counting purposes. The broader securities regulation framework — including what counts as a security under the Securities Act, the Investment Company Act regime, the Advisers Act, and the private-placement exemptions used by pooled investment vehicles — is the subject of Part IV.

### **8.1 Registration and Disclosure Units: Regulation S-K Item 202**

Section 5 of the Securities Act of 1933 requires that any offering of securities (subject to exemptions addressed in Part IV) be registered, and Regulation S-K Item 202 prescribes the description of the registrant's securities — including, for each class of voting securities, the title, dividend rights, voting rights, liquidation rights, preemptive rights, conversion rights, redemption provisions, sinking-fund provisions, and any liability for further calls or assessments. Section 12 of the Exchange Act requires registration of each class of securities listed on a national securities exchange and of each class of equity securities held of record by 2,000 or more persons (or 500 non-accredited investors) where the issuer has total assets exceeding \$10 million. A class for these purposes is determined by reference to state-law rights and the issuer's own designation; substantively identical classes generally must be aggregated.

## 8.2 Counting "Held of Record": Rule 12g5-1 and the JOBS Act Framework

The Exchange Act § 12(g) registration thresholds count shareholders "held of record," a term defined in Rule 12g5-1. The rule provides that securities are held of record by each person identified as the owner of those securities on records of security holders maintained by or on behalf of the issuer. As examined in Section 5 above, most publicly traded shares are held in street name through DTC and Cede & Co. Under Rule 12g5-1, all shares held through DTC are deemed held by a single record holder regardless of how many beneficial owners hold them. A private company with thousands of beneficial owners trading through DTC-affiliated brokers may, for § 12(g) purposes, have only one record holder. The 2012 JOBS Act amendments raised the principal § 12(g) threshold from 500 to 2,000 holders (with a 500-non-accredited subcap) and excluded employee compensation-plan shares from the count. The § 12(g) framework operates as an important practical constraint for private investment vehicles, as discussed in Part IV; the cross-reference here is to the technical mechanics of the held-of-record count.

## 8.3 Advanced Financial Engineering: Tracking Stock, Targeted Stock, and Segmented Architectures

Federal securities law accommodates more exotic classifications. "Tracking stock" (or "targeted stock") is a class of the parent corporation's common stock whose economic value is intended to reflect the performance of a particular subsidiary, division, or line of business. Holders of tracking stock are, technically, shareholders of the parent, not the subsidiary, and bear the full credit risk of the consolidated entity. But their economic returns are tied to the targeted segment through dividend formulas, liquidation preferences, and conversion provisions calibrated to the segment's performance. Historical examples include AT&T's Class V tracking stock for AT&T Wireless, Sprint's PCS and FON groups, and the Liberty Media tracking-stock complex. Tracking stock illustrates that "class" under state corporate law can be defined by reference to economic phenomena that go well beyond the traditional list of preferences and rights — but it must still be created through the standard certificate-of-incorporation mechanism, summarized on the certificate (or in the § 151(f) notice), and construed under the contract-rule principles of Section 3.

## 8.4 Restricted Securities and Resale Under Rule 144

Securities sold in transactions exempt from Securities Act registration — including the Reg D private placements treated in detail in Part IV below — are "restricted securities" within the meaning of Rule 144(a)(3). The restriction is that, in general, the securities may not be publicly resold without satisfying the conditions of Rule 144 or of another exemption from registration. The practical effect for the purchaser of a privately placed security is illiquidity: the security cannot be sold into the public markets without a registration statement, a Rule 144 sale, or a private resale to another qualified purchaser. The purchaser receives the security with a restrictive legend stating the restrictions, and the issuer's transfer agent will refuse to remove the legend except upon receipt of a legal opinion or other documentation establishing compliance with the resale conditions.

Rule 144 supplies a non-exclusive safe harbor for the resale of restricted securities. Its operative content depends on whether the holder is an "affiliate" of the issuer (i.e., a director, executive officer, or 10%-or-greater shareholder) and on whether the issuer is a reporting company under the Exchange Act. For non-affiliates holding restricted securities of a reporting issuer, Rule 144 permits unrestricted public resale after a six-month holding period (with continued availability of current public information for the period from six to twelve months, after which all conditions fall away). For non-affiliates of a non-reporting issuer, the holding period is one year, after which unrestricted resale is permitted. For affiliates of either type of issuer, Rule 144 imposes additional

ongoing conditions: a volume limit (1% of the outstanding class per three-month period, or, for reporting-issuer affiliates, the greater of 1% or the average weekly trading volume over the prior four weeks), a manner-of-sale requirement (sales must be effected as unsolicited brokers' transactions or through a market maker), the filing of Form 144 with the SEC for sales exceeding specified thresholds, and the continued availability of current public information.

Rule 144 matters in private fund practice principally in two respects. First, fund interests themselves are restricted securities, and the safe-harbor resale provisions of Rule 144 are, in practical effect, unavailable for them — fund LPAs invariably impose transfer restrictions far more onerous than Rule 144 would require, and the substantive policy of the §§ 3(c)(1) and 3(c)(7) exclusions (no public offering) is incompatible with general resale. Investor exits from private funds are accomplished primarily through redemption (for open-end private funds) or through secondary transactions in the secondary fund market, not through public resale. Second, where the fund holds restricted securities issued by portfolio companies (a common position for venture funds and growth-equity funds), the fund's ability to liquidate those positions on a portfolio-company IPO or follow-on offering is constrained by Rule 144 and by lock-up agreements with the underwriters. The interaction between Rule 144, exchange lock-ups, and the fund's distribution and liquidation timing is a routine portfolio-management consideration.

## **Section 9. Stock-Exchange Listing Standards and Corporate Governance Overlays**

### **9.1 Voting-Rights Disparities and Protections: NYSE § 313, Nasdaq Rule 5640, and the Legacy of Rule 19c-4**

NYSE Listed Company Manual § 313 and Nasdaq Rule 5640 prohibit listed issuers from taking corporate action that has the effect of nullifying, restricting, or disparately reducing the voting rights of existing common shareholders. These rules descend from former SEC Rule 19c-4, adopted in 1988 and struck down in 1990 by the D.C. Circuit in *The Business Roundtable v. SEC* for exceeding the Commission's authority under Section 19(c) of the Exchange Act. Following that decision, the exchanges themselves adopted substantially the same standard as a listing requirement, against which the Business Roundtable jurisdictional objection had no purchase. In practical effect, the rules permit dual-class structures established at the time of an IPO (the "IPO carve-out") but generally prohibit mid-stream recapitalizations that would create disparate voting rights among existing classes of common stock.

### **9.2 Market-Imposed Disincentives: Dual-Class Sunset Provisions**

The static rule has been substantially modified, in practice, by market forces operating outside the formal listing requirements. Technology-sector issuers — Google (2004), Facebook (2012), Snap (2017), and many others — have adopted founder-favoring dual-class structures granting high-vote stock to founders and management. Institutional investors and proxy-advisory firms responded by demanding mechanisms ensuring such structures do not persist indefinitely. The result has been the widespread adoption of dual-class "sunset" provisions. Time-based sunsets cause conversion at the end of a stated period (commonly seven or ten years from IPO). Event-based sunsets convert upon death or permanent incapacity of the founder, voluntary transfer outside permitted transferees, or a decline in the founder's ownership below a stated threshold.

### **9.3 Soft-Law Filters: Index Provider Restrictions and Proxy Advisory Policies (ISS, Glass Lewis)**

These sunsets are not required by the formal listing rules; they are the product of soft-law pressure. Institutional Shareholder Services and Glass Lewis publish formal voting policies treating the absence of a meaningful sunset as grounds for opposing director nominees. Major index providers including S&P Dow Jones Indices and FTSE Russell have at various points limited or excluded companies with unmitigated dual-class structures from flagship indices, affecting their inclusion in index-tracking funds. The cumulative effect is that while state corporate law continues to permit dual-class structures of indefinite duration, modern U.S. public-company practice routinely includes sunset mechanics — a market-imposed overlay that the formal listing rules do not require but that public markets effectively demand.

## PART IV

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### PART IV — REGULATION OF POOLED INVESTMENT VEHICLES AND CORPORATE FUNDS

The final level of particularity applies when corporate shares are issued by, or purchased by, collective investment vehicles. This consolidates the foundational equity concepts of Parts I–III into the heavily regulated domain of fund formation and investment adviser compliance. The federal securities laws constitute, alongside the Internal Revenue Code, the second great regulatory overlay that shapes the design of investment vehicles. An entity that is properly designed and operated as a private investment vehicle is one that has been engineered, deliberately and at every stage of its life cycle, to remain outside the most onerous of these regimes.

Six federal statutes are of central importance. The Securities Act of 1933 governs the offer and sale of securities. The Securities Exchange Act of 1934 governs trading markets and the ongoing reporting obligations of public companies. The Investment Company Act of 1940 governs the organization and operation of pooled investment vehicles. The Investment Advisers Act of 1940 governs persons in the business of providing investment advice for compensation. The Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 amended each of the foregoing in respects material to fund formation practice. The State "blue-sky" laws supply a seventh dimension, partially preempted since 1996 by the National Securities Markets Improvement Act.

Three distinct registration regimes operate under these statutes, and they must not be confused. They are independent of one another, they ask different questions, and an entity may be subject to one and exempt from another. First, registration of the fund as an investment company under the 1940 Act. The question is whether the entity that issues the securities (the fund vehicle itself) is an investment company, and if so, whether it must register with the SEC as such. Second, registration of the manager as an investment adviser under the Advisers Act. The question is whether the firm that provides investment advice for compensation — the fund's manager, typically a separate legal entity from the fund — is itself required to register with the SEC (or with one or more States) on the manager's own account. Third, registration of the securities being offered under the Securities Act. The question is whether the fund's issuance of LP interests, membership interests, or shares to investors must be registered with the SEC as a public offering, or instead may rely on an exemption such as Rule 506(b). The three inquiries are logically and legally independent, and a fund formation analysis must address each one separately.

Two further distinctions are foundational and are likewise often confused. The first is between a public offering and a private offering of securities. A public offering is one that is registered with the SEC under § 5 of the Securities Act (via Form S-1, S-3, N-1A, N-2, or similar), with a prospectus disclosed to the investing public and the offering available without restriction. A private offering — also called a private placement — is one that relies on a statutory or regulatory exemption from § 5 registration, typically Section 4(a)(2) of the Securities Act or Regulation D thereunder, and is restricted to a defined class of qualifying investors. The distinction is about the offering itself — about how the securities are sold — not about what the issuer is.

The second distinction is between a public investment vehicle and a private investment vehicle. A public investment vehicle is an investment company that is registered under the 1940 Act — a mutual fund, an ETF, a closed-end fund, a unit investment trust, or a business development company. A private investment vehicle is a pooled investment vehicle that is excluded from the definition of an investment company under one of the § 3(c) exclusions (most commonly § 3(c)(1) or § 3(c)(7)) and is therefore not registered with the SEC as an investment company at all. The distinction is about the issuer itself — about what the fund vehicle is — not about how it sells its securities.

The two distinctions tend to correlate, but they do not necessarily coincide, and the technical separation matters. A public investment vehicle (mutual fund) typically conducts a public offering of its securities — its shares are registered under the Securities Act, sold continuously to the investing public, and offered with a Form N-1A prospectus. A private investment vehicle (hedge fund, PE fund, VC fund) typically conducts a private offering of its interests — it relies on Rule 506(b) or 506(c) of Regulation D and limits investors to accredited investors or qualified purchasers. But the correlation is not airtight. A business development company is a registered investment company under the 1940 Act and yet, before its initial public offering, may have raised its first capital through Reg D private placements. A private fund relying on § 3(c)(7) may, since 2013, conduct a Rule 506(c) offering that uses general solicitation — a feature historically associated only with public offerings. The vehicle classification and the offering classification are independent inquiries that happen, in the ordinary case, to point in the same direction.

Part IV is organized around the four operative questions every fund formation lawyer must answer before structure is finalized. First, what counts as a security, such that the offer and sale of the fund's interests implicates the federal securities laws at all (Section 10.1). Second, what are the consequences if the fund itself is an "investment company" within the meaning of the 1940 Act, and how does the fund qualify for an exclusion (Sections 10.2, 10.3, and 11.1–11.2). Third, how does the fund offer its interests without registration under the Securities Act, and which Regulation D safe harbor applies (Section 11.3). Fourth, what is the regulatory status of the fund's manager under the Advisers Act, and what registration obligations follow (Section 12).

## **Section 10. Foundational Triggers of Fund and Investment Regulation**

### **10.1 The Statutory Definition of a "Security" under the 1933 Act**

Section 5 of the Securities Act is the foundational provision of U.S. securities regulation. It provides that, subject to specified exemptions, no person may offer or sell a security in interstate commerce unless a registration statement is in effect with respect to the security. The penalty for non-compliance is severe: under § 12(a)(1), any person who offers or sells a security in violation of § 5 is liable to the purchaser for rescission, with interest, less any income received on the security. Section 5 thus operates as the gateway provision: every offering of a security is either registered (the public-offering route) or exempt (the private-placement route).

The threshold question is therefore whether the instrument being offered is a "security" within the meaning of § 2(a)(1) of the Securities Act, which supplies a long enumerated list followed by a residual catch-all "investment contract" category. The enumerated items — "any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement," and so on — capture most conventional financial instruments. The residual investment-contract category is the category of greatest doctrinal interest, because it captures arrangements that are not formally cast as conventional securities but that nevertheless resemble them in economic substance.

**(a) *The Howey Test for Investment Contracts***

The canonical formulation of the investment-contract test is the four-part Howey test of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946): an arrangement is an investment contract if there is (i) an investment of money, (ii) in a common enterprise, (iii) with an expectation of profits, (iv) to be derived from the efforts of others. Each prong has been the subject of substantial case-law development. The "common enterprise" prong has produced a divergence among the Federal Circuits, with some adopting "horizontal commonality" (pooling of investor funds and pro-rata sharing of profits and losses) and others adopting "vertical commonality" (linkage of investor fortunes to the promoter's efforts). The "expectation of profits" prong was elaborated in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), distinguishing between the consumption motive and the investment motive. The "efforts of others" prong was elaborated in *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973), which adopted the formulation that the relevant efforts must be "the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise."

**(b) *The Reves Test for Notes***

For the specific case of notes (which are independently enumerated in § 2(a)(1) but with a long history of confusion about whether commercial paper, promissory notes, and similar instruments are securities), the Supreme Court adopted in *Reves v. Ernst & Young*, 494 U.S. 56 (1990), a "family resemblance" test. The Court began with a presumption that any note is a security, then identified four factors that may rebut the presumption: (i) the motivations of the buyer and seller (investment vs. commercial purpose); (ii) the plan of distribution (broad public offering vs. limited private placement); (iii) the reasonable expectations of the investing public; and (iv) the existence of an alternative regulatory regime reducing the risk of the investment. The Court further identified a list of "family resemblance" categories of notes that are not securities — short-term commercial paper, notes secured by a mortgage on a home, notes evidencing a character loan to a bank customer, and similar arrangements. *Reves* matters in fund practice principally because private credit funds, syndicated loan vehicles, and direct lending structures must assess whether the loan documentation they originate or hold is itself a "security," with cascading consequences under the 1940 Act (because securities count toward the 40% test) and the registration and disclosure requirements of the Securities Act and the Advisers Act.

**(c) *Limited Partnership Interests***

Limited partnership interests in private investment funds are universally treated as securities. The conclusion is overdetermined: limited partnership interests are explicitly enumerated in § 2(a)(1) as "certificates of interest or participation in any profit-sharing agreement," and they satisfy Howey on their facts (limited partners by definition contribute capital to a common enterprise managed by the general partner, with an expectation of profits derived from the GP's investment efforts). The Supreme Court confirmed the treatment in dictum in *Howey* itself, and no contrary authority of significance exists. For practical purposes, every limited partnership interest in a private fund context is a security.

**(d) *LLC and General Partnership Interests: When Management Rights Defeat Security Status***

The analysis is materially different — and materially more nuanced — for interests in entities whose members or partners are formally vested with management authority. Two categories matter: interests in member-managed LLCs and interests in general partnerships. In neither case is the Howey "efforts of others" prong automatically satisfied, because the holder is, on paper, responsible for the relevant efforts. Whether the interest is in fact a security depends on the substance of the arrangement, not its form.

The seminal authority is *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), which addressed the question whether interests in a joint venture formally structured as a general partnership constituted securities. The Fifth Circuit held that the formal allocation of management rights to the holder creates a strong presumption that the interest is not a security, but that the presumption may be rebutted if the investor demonstrates that the interest in fact functions as a passive investment. The court identified three rebuttal showings, any one of which suffices to establish security status:

- the partnership or LLC agreement leaves so little power in the hands of the investor that the arrangement in fact distributes power as would a limited partnership;
- the investor is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his managerial powers; or
- the investor is so dependent on the unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace him or otherwise exercise meaningful partnership powers.

Absent any of these showings, the partnership or member-managed LLC interest is presumed not to be a security. The classic non-security case is the closely held operating business, formed as an LLC or general partnership, in which two or three founders contribute capital and labor and jointly run the business. Each founder has equal information, equal voice, equal exit rights, and equal managerial responsibility; none is dependent on the efforts of the others in the *Howey* sense. Examples include a two-doctor medical practice formed as an LLC, a three-partner real estate development firm structured as a general partnership, a family-run restaurant LLC in which all members work in the business, and a professional services LLC of equal owner-operators. In each case, the members are the enterprise, not investors in the efforts of someone else, and their interests are not securities.

Conversely, where the formal allocation of management rights is nominal — where most members are passive capital providers and a single member or a small group exercises *de facto* control — the interests are likely to be held securities notwithstanding the formal labels. The cases are heavily fact-specific. See generally *SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007) (general partnership interests held to be securities where investors had no practical ability to exercise their formal management rights); *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003) (LLC interest held not a security where the investor in fact participated meaningfully in management). For a manager-managed LLC, by contrast, the analysis is uniformly that the interest is a security: members have no management rights as such, and the manager is the person whose efforts produce profits. Stock of a corporation, by enumeration in § 2(a)(1) and under *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), is always a security regardless of the holder's role.

## 10.2 The Core Regulatory Trigger: What Constitutes an "Investment Company" under the 1940 Act

For private investment vehicles, the central and overriding objective of 1940 Act analysis is to remain outside the Act's reach. The analysis proceeds in two steps. First, does the entity meet the definition of an "investment company" under § 3(a)? Second, if so, does an exclusion under § 3(c) apply (addressed in Section 11 below)?

Section 3(a)(1) supplies three independent definitions of "investment company." Any one of them suffices to bring an entity within the Act's scope. The three tests, in order of practical importance:

- **The "primarily engaged" test (§ 3(a)(1)(A)).** An entity is an investment company if it is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. This is a facts-and-circumstances test that examines, among other things, the entity's

historical development, its public representations, the activities of its officers and directors, the nature of its assets, and the source of its income — the so-called Tonopah factors from *In the Matter of Tonopah Mining Co. of Nev.*, 26 S.E.C. 426 (1947).

- **The face-amount certificate test (§ 3(a)(1)(B)).** An entity is an investment company if it issues face-amount certificates of the installment type. A "face-amount certificate" is a category rooted in the 1920s: a contract under which the issuer promises to pay a stated ("face") amount to the holder at a fixed maturity date, with the holder paying the issuer in installments before maturity. The product is economically a long-dated savings instrument with a fixed-income payoff and was sold widely to retail investors before mutual funds became the dominant retail investment product. The 1940 Act preserved the category as a distinct subset of investment companies because of the special abuses associated with face-amount-certificate companies during the pre-1940 era. The category survives in §§ 28 and 29 of the 1940 Act (prescribing capital, reserve, and investment requirements for face-amount-certificate companies), but the number of currently registered face-amount-certificate companies is in the low single digits and the category has no contemporary relevance to fund formation. It is addressed here only for completeness of the § 3(a)(1) definitional structure.
- **The 40% test (§ 3(a)(1)(C)).** An entity is an investment company if it is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities and owns or proposes to acquire "investment securities" having a value exceeding 40% of the value of the entity's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. The definition of "investment securities" in § 3(a)(2) excludes Government securities, securities issued by employees' securities companies, and (critically) securities issued by majority-owned subsidiaries of the entity that are not themselves investment companies and are not relying on §§ 3(c)(1) or 3(c)(7) for their own exclusion.

The 40% test is, in practice, the binding constraint for most operating businesses that hold financial assets. A holding company that owns 80% subsidiaries engaged in operating businesses is generally outside the test because the subsidiary securities are excluded from the numerator. A holding company that holds a portfolio of minority equity stakes, however, may readily exceed the 40% threshold and require analysis under the Act's exemptions. The SEC's Rule 3a-1 supplies a safe harbor for certain asset-composition profiles, and Rule 3a-2 supplies a one-year transient investment company safe harbor for an issuer that finds itself inadvertently above the 40% threshold.

**Table 10.2-1 — When an Entity Is an Investment Company**

Test	When triggered	Practical application
<b>§ 3(a)(1)(A) — "Primarily Engaged" Test</b>	Entity is or holds itself out as engaged primarily in investing, reinvesting, or trading in securities. Tonopah factors examined: historical development; public representations; activities of officers and directors; nature of assets; source of income.	Catches entities whose actual conduct or self-presentation is that of an investment manager, even if asset thresholds are not crossed.
<b>§ 3(a)(1)(B) — Face-Amount Certificate Test</b>	Entity issues face-amount certificates of the installment type.	Historical category, rarely encountered in modern practice.
<b>§ 3(a)(1)(C) — 40% Test</b>	Investment securities exceed 40% of total assets (excluding Government securities and cash). Majority-owned operating subsidiaries are excluded from the numerator under § 3(a)(2).	The binding constraint for most holding companies. Triggered by portfolios of minority equity stakes; avoided by structures owning 80%+ operating subsidiaries.
<b>Rule 3a-1 Safe Harbor</b>	Not more than 45% of total assets and not more than 45% of net income from investment securities (and other tests).	Asset-composition safe harbor for operating companies holding incidental securities portfolios.
<b>Rule 3a-2 Transient Issuer</b>	Issuer with bona fide intent to become non-investment-company within one year may rely on this exemption once every three years.	Used for entities in transition (e.g., post-IPO companies; entities redeploying capital).

### 10.3 The Consequences of Registration: Structural Rigidities of Public Mutual Funds and ETFs

Before turning to the exclusions on which the entire private fund industry rests (Section 11 below), it is useful to understand at the outset why so much structural ingenuity is devoted to remaining outside the 1940 Act's coverage. An entity that registers as an investment company — or that is required to register and has failed to do so — is subject to a regulatory regime far more intrusive than the disclosure-based regimes of the Securities Act and the Exchange Act. The 1940 Act regulates the registrant's capital structure, governance, transactions with affiliates, advisory contracts, custody arrangements, pricing methods, redemption rights, recordkeeping, compliance program, and external audit relationships. Each of these areas imposes substantive operating restrictions that are flatly incompatible with the customary operating model of a private investment fund. And the consequence of being subject to registration without having registered is not merely the prospective burden of compliance: under § 47(b) of the 1940 Act, contracts made in violation of the Act may be voidable, and transactions effected by an unregistered investment company are exposed to rescission and damages liability.

This subsection is framed deliberately around the public-vehicle perspective. It is included to provide the contrast and context against which the private-vehicle structures of Section 11 are designed. The principal obligations imposed on a registered investment company are summarized below. The list is illustrative, not exhaustive.

- **Capital-structure limitations under § 18.** Section 18 prohibits an open-end fund from issuing senior securities other than bank borrowings and limits any such borrowing to a level that maintains 300% asset

coverage at the time the borrowing is incurred. The 300% test translates to a 1:2 debt-to-equity ratio: total assets must equal at least three times senior debt, which means that for every \$1 of borrowing the fund must hold \$3 of total assets (\$2 of which is equity). For a closed-end fund, § 18 permits one class of senior securities representing indebtedness subject to the same 300% coverage test and one class of preferred stock subject to a 200% coverage test. Cross-class senior security structures are generally prohibited. The substantive consequences are profound: a registered fund cannot run the levered strategies typical of hedge funds or the highly levered structures typical of credit and CLO managers without operating under § 18's binding constraint.

- **Transactions-with-affiliates prohibitions under §§ 17(a), 17(d), and 17(e).** Section 17(a) prohibits an "affiliated person" of a registered investment company (defined broadly to include officers, directors, the adviser, 5% holders, and entities under common control) from selling property to or purchasing property from the fund. Section 17(d) and Rule 17d-1 prohibit joint transactions between the fund and an affiliated person, including co-investments by the adviser and the fund in the same portfolio company absent a Commission exemptive order. Section 17(e) restricts the compensation that may be paid to an affiliated person acting as agent or broker for the fund. The practical consequence is that cross-trades between funds in the same complex, principal transactions with the adviser, and many co-investment arrangements that are routine in private fund practice are unavailable to a registered fund without case-by-case Commission relief.
- **Board composition under § 10(a).** Section 10(a) requires that at least 40% of the board of directors of a registered investment company consist of persons who are not "interested persons" within the meaning of § 2(a)(19), and in practice — because § 15(c) and Rule 10f-3 (among others) require that certain matters be approved by a majority of independent directors — most fund complexes maintain boards on which a majority (often supermajority) of the directors are independent. The definition of "interested person" extends well beyond formal affiliation and is the source of significant compliance attention.
- **Pricing and valuation under § 22(c) and Rule 22c-1.** Rule 22c-1 requires that open-end funds price their shares for purchase, redemption, and exchange at the net asset value next computed after receipt of the order (the "forward pricing" requirement), and requires daily computation of NAV in accordance with prescribed methodologies. The valuation rules under Rule 2a-5 (adopted in 2020) prescribe the methodology by which fair-value determinations for portfolio securities lacking readily available market quotations must be made. These rules collectively dictate the timing and methodology of the fund's daily operations.
- **Advisory contract requirements under § 15.** Section 15 requires that the fund's advisory contract be approved initially by a majority of outstanding voting securities of the fund and annually thereafter (after the first two years) by either the board (including a majority of independent directors) or shareholders. Section 15(c) requires the board, in connection with annual approval, to evaluate specified factors (the so-called Gartenberg factors) bearing on the reasonableness of the advisory fee. Section 15(a)(4) prohibits the assignment of the advisory contract, which has been read to terminate the contract upon any change of control of the adviser — a constraint of significant relevance to M&A transactions involving fund advisers.
- **Custody requirements under § 17(f) and Rule 17f-2.** Section 17(f) and the rules thereunder require a registered fund to maintain custody of its securities and other assets with a qualified bank custodian, with limited exceptions for self-custody (subject to enhanced controls) and for non-U.S. securities held with eligible foreign custodians under Rule 17f-5. The custody rules are highly prescriptive and significantly more demanding than the analog custody rule under the Advisers Act applicable to unregistered private funds.

- **Distribution and Rule 12b-1 fees.** Rule 12b-1 governs the payment of fund assets for distribution activities, including a board-approved written plan, annual board review, and shareholder vote requirements. Distribution arrangements that would be straightforward for a private fund (placement agent fees, marketing expenses) are subject to detailed substantive constraints when paid by a registered fund.
- **Recordkeeping, reporting, and disclosure.** A registered fund is required to file an initial registration statement on Form N-1A (open-end), N-2 (closed-end), or N-4 (variable insurance product); annual and semi-annual reports to shareholders; periodic portfolio disclosures on Forms N-PORT and N-CEN; reports of proxy voting on Form N-PX; and a long list of additional filings. Recordkeeping requirements under § 31 and Rule 31a-1 prescribe in detail the books and records that must be maintained.
- **Compliance program under Rule 38a-1.** Rule 38a-1 requires the fund to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, to designate a chief compliance officer reporting to the board, and to conduct annual reviews of the compliance program.
- **Redemption obligations under § 22(e).** Open-end funds are required to redeem outstanding shares on demand within seven days of receipt of a redemption request, with very narrow exceptions. The result is a structural mismatch with any illiquid investment strategy — a constraint that is the principal reason that private equity, venture, real estate, and credit funds are organized as private funds outside the 1940 Act rather than as registered open-end funds.

Taken together, these provisions render the registered investment company form unsuitable for any investment strategy involving leverage above modest levels, illiquid investments, transactions with affiliates, performance-based compensation outside the narrow confines of § 205, or operating flexibility of the kind taken for granted in private fund practice. The avoidance of 1940 Act registration is, in consequence, the single most important structural objective in private fund formation, and the §§ 3(c)(1) and 3(c)(7) exclusions (Section 11 below) are the structural foundation upon which the entire private fund industry rests.

## Section 11. The Structural Pathways of Private Investment Vehicles

Of the various exclusions enumerated in § 3(c) of the 1940 Act, two are indispensable to private fund practice: § 3(c)(1) and § 3(c)(7). These two provisions, paired with the Securities Act registration exemptions of Section 4(a)(2) and Regulation D — addressed in Section 11.3 — form the structural foundation of the entire U.S. private fund industry. Every hedge fund, private equity fund, venture capital fund, and similar pooled vehicle organized in the United States relies on one of these exclusions, and one of the Reg D safe harbors, in some combination.

### 11.1 The § 3(c)(1) Exception: The 100-Beneficial-Owner Limitation and Look-Through Rules

Section 3(c)(1) excludes any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and that is not making and does not propose to make a public offering of its securities. The 100-person count is the structural foundation of the "private fund." Section 3(c)(1) is available regardless of investor wealth, but the 100-person count is rigorously enforced — exceeding it by even one investor causes the entity to lose the exclusion and to become an unregistered investment company in violation of the Act.

Beneficial ownership for § 3(c)(1) purposes is generally counted as one per record holder, but § 3(c)(1)(A) requires look-through to the beneficial owners of certain holders that are themselves investment companies,

and the "knowledgeable employee" exclusion under Rule 3c-5 excludes certain employees of the adviser (and certain other persons participating in the management of the fund) from the count. In a fund-of-funds context, where one of the investors is itself a 3(c)(1) fund holding 10% or more of the lower-tier fund, look-through to the upper fund's beneficial owners is required — a provision designed to prevent multiplication of the 100-person limit through stacked feeder structures. In practical terms, look-through compels a fund-of-funds manager to inquire into the upper-fund's investor base, a routine due-diligence item in side-letter negotiations.

The penalty for inadvertent exceedance of the 100-person limit under § 3(c)(1) is loss of the exclusion and exposure to the 1940 Act's registration requirements — a catastrophic outcome that requires close attention to investor counts throughout the fund's life. Standard practice is to set the operative target at 95 or fewer beneficial owners, leaving headroom for inadvertent breaches (e.g., death of an investor leading to multiple beneficial owners by estate distribution, divorce-related transfers that split a single investor into two, or transfers among related entities).

### **11.2 The § 3(c)(7) Exception: The "Qualified Purchaser" Standard and Structural Scalability**

Section 3(c)(7) (added in 1996 by NSMIA) excludes any issuer whose outstanding securities are owned exclusively by qualified purchasers and that is not making and does not propose to make a public offering. A "qualified purchaser" is defined in § 2(a)(51) and generally includes (i) natural persons owning not less than \$5 million in "investments" as defined in Rule 2a51-1; (ii) family-owned companies owning not less than \$5 million in investments; (iii) trusts whose trustees and settlors are qualified purchasers; and (iv) entities, acting for their own account or for the account of other qualified purchasers, that in the aggregate own and invest on a discretionary basis not less than \$25 million in investments. Section 3(c)(7) imposes no numerical cap on investor count; the operative constraint is the qualified-purchaser eligibility threshold for every investor.

For institutional-quality funds with high investor minimums (typically \$5 million and above), § 3(c)(7) is preferred. For funds targeting a smaller investor base of accredited but not qualified-purchaser-level individuals, § 3(c)(1) is the necessary vehicle. The two exclusions may be combined in master-feeder structures: a Cayman master fund relying on § 3(c)(7), with U.S. and offshore feeders that may rely on § 3(c)(1), § 3(c)(7), or both, is the industry-standard architecture for funds accepting both U.S. taxable, U.S. tax-exempt, and non-U.S. investors. The penalty for inadvertent admission of a non-qualified-purchaser under § 3(c)(7) is, again, loss of the exclusion and exposure to the 1940 Act's registration requirements — and accordingly, § 3(c)(7) funds enforce QP-status verification at intake with substantial rigor.

#### ***Other Exclusions of Practical Importance***

Several other exclusions are of practical importance for specific strategies. Section 3(c)(5)(C) excludes entities "primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate" — the foundation of the mortgage REIT and many real estate credit fund structures. Section 3(c)(5)(A) and (B) cover certain factoring and consumer-finance entities. Section 3(c)(6) addresses holding companies of § 3(c)(5) entities. Section 3(c)(11) excludes qualified employee benefit plans. Real estate equity funds typically rely on the SEC's longstanding interpretive position that a fund engaged exclusively in the direct acquisition and ownership of real estate is not an investment company at all, since real estate is not a security and the fund therefore fails the threshold "engaged in the business of investing in securities" requirement of § 3(a)(1). Rule 3a-7 provides a separate exclusion for structured-finance vehicles (CLOs, ABS issuers) holding eligible assets and satisfying detailed structural and rating-agency requirements.

#### ***Table 11.2-1 — Choosing Among the 1940 Act Exclusions***

Exclusion	Investor eligibility	Numerical limit	Typical use case
<b>§ 3(c)(1)</b>	No statutory wealth threshold; in practice limited to accredited investors by Securities Act Rule 506.	Not more than 100 beneficial owners.	Smaller funds; emerging-manager funds; funds accepting friends-and-family or HNW investors below QP thresholds.
<b>§ 3(c)(7)</b>	Qualified purchasers only (\$5M for individuals; \$25M for entities).	No statutory limit; in practice limited by § 12(g) of the Exchange Act to fewer than 2,000 holders of record.	Institutional-grade funds; hedge funds with HNW/UHNW investor base; preferred where investor minimums are at or above \$5M.
<b>§ 3(c)(5)(C)</b>	No statutory investor restriction (but Securities Act exemption still required).	No numerical limit (but other regulatory regimes apply).	Mortgage REITs; real estate credit funds; mortgage-backed securities investors.
<b>Direct real estate (interpretive)</b>	No statutory investor restriction.	No numerical limit.	Funds investing directly in real property rather than in mortgages or REIT securities.
<b>Rule 3a-7</b>	Various structural and rating-agency requirements.	Various.	Structured finance vehicles (CLOs, ABS issuers) holding eligible assets.

### 11.3 Capital Raising Exemptions: Section 4(a)(2) and Regulation D (Rules 506(b), 506(c), and 504)

The mechanic of the Securities Act bears restating clearly. Section 5 prohibits any offer or sale of a security in interstate commerce unless either (a) a registration statement covering the security is in effect or (b) the offer and sale qualifies for an exemption from registration. There is no third path: every transaction in a security must travel one of these two routes.

A private investment vehicle, in principle, could register its securities. Nothing in the Securities Act prohibits the registration of LP interests or LLC membership interests in a private fund. In practice, however, no private fund does so. The reasons are practical rather than legal: registration would require the preparation of a full prospectus with line-item disclosure of investment strategy, fee structure, and risk factors; it would subject the fund to continuous Exchange Act reporting under § 15(d) of the Exchange Act; it would create securities that are freely tradable by the holders (the very feature private funds are designed to avoid, both because illiquid investments require investor lock-ups and because §§ 3(c)(1) and 3(c)(7) of the 1940 Act condition the private-fund exclusions on the absence of a public offering); and it would impose administrative costs and disclosure burdens that are economically prohibitive for a vehicle whose securities are sold once to a small investor base. The registered investment company form under the 1940 Act exists precisely for issuers prepared to undertake those burdens; the private fund is, by design, the alternative for issuers that are not.

Private investment vehicles therefore, as a matter of universal industry practice rather than legal compulsion, rely on a registration exemption. The principal exemptions are Section 4(a)(2) of the Securities Act and the related safe harbors supplied by Regulation D under Rules 504, 506(b), and 506(c). The remainder of this subsection addresses these exemptions in turn.

#### (a) Section 4(a)(2) — The Statutory "Sophisticated Investor" Exemption

Section 4(a)(2) — also commonly described as the statutory private-placement exemption or the sophisticated investor exemption — exempts from § 5 "transactions by an issuer not involving any public offering." The exemption turns not on the characteristics of the security or the size of the offering but on the nature of the offerees. The seminal interpretation is the Supreme Court's decision in *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), which held that the exemption turns on whether the offerees are persons who "are shown to be able to fend for themselves" — that is, persons whose access to information of the type that would be available in a registration statement, and whose sophistication, are sufficient to obviate the need for the disclosure protections of registration.

The Ralston Purina standard remains the operative test for § 4(a)(2) offerings that do not fit within Regulation D. In practice, fund offerings rely primarily on Rule 506 of Regulation D below because the safe-harbor character of Rule 506 provides considerably more predictability than reliance on § 4(a)(2) standing alone. But Rule 506(b) is itself a safe harbor under § 4(a)(2), and the Ralston Purina sophistication principles continue to inform the design of fund offering practices, particularly the requirement of a substantive pre-existing relationship with each offeree under Rule 506(b).

***(b) Regulation D — The Principal Safe Harbors***

Regulation D (17 C.F.R. §§ 230.500–230.508) supplies a series of safe harbors under § 4(a)(2) and § 3(b) of the Securities Act. The three currently operative safe harbors are Rules 504, 506(b), and 506(c) (the former Rule 505 was repealed in 2017). Of these, Rules 506(b) and 506(c) are the safe harbors of relevance to private investment vehicles.

**Rule 506(b) — Traditional private placement (no general solicitation).** Rule 506(b) is the dominant safe harbor for private fund offerings and warrants extended treatment. Its operative content is straightforward in statement but rich in practical implication. Rule 506(b) permits an unlimited offering amount to an unlimited number of accredited investors (as defined in Rule 501(a)) and to up to 35 non-accredited investors who meet a sophistication standard substantially comparable to Ralston Purina. The principal restriction is that the offering may not involve general solicitation or general advertising within the meaning of Rule 502(c) — a restriction that effectively requires the issuer to have a substantive pre-existing relationship with each offeree before the offering is made.

In practical terms, a Rule 506(b) offering proceeds as follows. The fund's offering documents — typically a confidential private placement memorandum (PPM), the fund's limited partnership agreement or operating agreement, a subscription agreement, and an investor questionnaire — are prepared in confidential form and shared only with prospective investors who pass an initial qualification screen and execute a confidentiality undertaking. The investor questionnaire collects representations sufficient to establish the investor's accredited (or sophisticated non-accredited) status. The investor's self-certification of accredited status is permitted under Rule 506(b), in contrast to Rule 506(c), discussed below, which requires affirmative verification. Subscription closes are typically conducted in tranches, with the first closing requiring a minimum aggregate commitment and subsequent closings admitting additional investors on substantively identical terms.

Most private fund offerings — by a wide margin — proceed under Rule 506(b). The reasons are practical: (i) self-certification of accredited status is simpler and less invasive than the verification regime of Rule 506(c); (ii) the absence of general solicitation aligns with the no-public-offering condition of § 3(c)(1) and § 3(c)(7) of the 1940 Act, eliminating a layer of analytical complexity; (iii) Rule 506(b) is available even where there is no general solicitation infrastructure; and (iv) the limit on non-accredited investors (35) supplies modest flexibility for small founder, friends-and-family, or knowledgeable-employee allocations without forfeiting the safe harbor.

**Rule 506(c) — General solicitation permitted; accredited-only.** Rule 506(c), added in 2013 in response to the JOBS Act of 2012, permits an offering to be made by means of general solicitation provided that (i) all purchasers are accredited investors and (ii) the issuer takes "reasonable steps to verify" their accredited-investor status (a more demanding standard than the self-certification permitted under Rule 506(b)). Rule 506(c) was widely expected to displace Rule 506(b) for fund offerings, but its practical adoption has been more limited than anticipated: the verification requirement is more burdensome, the use of general solicitation creates 1940 Act issues for funds relying on § 3(c)(1) or § 3(c)(7) (the no-public-offering element of those exclusions), and general solicitation interacts unfavorably with the Advisers Act marketing rule.

**Rule 504 — Small offerings up to \$10 million.** Rule 504 permits an offering of up to \$10 million in any twelve-month period, subject to a more limited integration analysis. Notably, Rule 504 imposes no statutory investor-eligibility requirements: there is no accredited-investor requirement, no qualified-purchaser requirement, no sophistication standard, and no investor numerical cap. The issuer may sell to any purchaser, accredited or not. The trade-off is twofold. First, Rule 504 is not available to Exchange Act reporting companies, investment companies, or blank-check companies (with the consequence that pooled investment vehicles relying on the §§ 3(c)(1) or 3(c)(7) exclusions can use Rule 504 only on a careful structural reading). Second, Rule 504 is not a covered-security safe harbor under NSMIA, so State blue-sky registration or exemption is required in every State of offer. Rule 504 is rarely used in fund formation because the offering cap is too low to support a meaningful institutional fund, but it is occasionally employed for ancillary vehicles such as small co-investment SPVs or for managers raising modest amounts before scaling up.

***(c) General Solicitation and General Advertising — The Operative Distinction***

Because the distinction between Rule 506(b) and Rule 506(c) turns entirely on whether the offering involves general solicitation or general advertising, the operative content of those terms warrants close attention. The terms are defined functionally rather than by enumeration: Rule 502(c) describes general solicitation and general advertising as including, but not limited to, (i) any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar medium or broadcast over television or radio and (ii) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. The category is broad and the SEC has consistently interpreted it expansively.

Activities clearly constituting general solicitation include: published advertisements (print, online, social media); mass email or mass postal mailings to recipients without a pre-existing relationship; cold-calling telephone campaigns; press releases announcing the offering; investor presentations and pitch decks distributed without screening; appearances on financial news programs to promote a fund's offering; publicly accessible websites describing the offering and inviting investment; Twitter or LinkedIn posts that are visible to non-followers and invite investment; and any public-facing seminar, conference, or networking event held to attract investors.

Activities that do not constitute general solicitation, by contrast, include communications with persons with whom the issuer or its placement agent has a substantive pre-existing relationship. A pre-existing relationship is one established before the commencement of the offering; a substantive relationship is one in which the issuer (or its agent) has sufficient information about the prospective investor to evaluate the investor's financial circumstances and sophistication. The SEC has long taken the position, through a sequence of no-action letters culminating in the 2015 Citizen VC, Inc. letter, that a properly operated online investor portal with a meaningful pre-screening questionnaire can establish a substantive pre-existing relationship even with persons not previously known to the issuer. Beyond the pre-existing-relationship doctrine, communications restricted to existing limited partners of the same sponsor's prior funds, communications with consultants and

intermediaries acting for institutional investors, and responses to unsolicited inquiries are generally not general solicitations.

The 2020 SEC amendments codified a series of "demo-day" safe harbors under Rule 148, providing that certain communications at sponsored events held by colleges, universities, government agencies, incorporated nonprofits, and angel-investor groups will not constitute general solicitation if specified conditions are met. These safe harbors are of limited utility in institutional fund formation but are important in early-stage venture practice.

The practical consequence of the general-solicitation classification is binary. If the offering does not involve general solicitation, the issuer may rely on Rule 506(b), which permits up to 35 non-accredited (but sophisticated) purchasers and permits the issuer to rely on the investor's own representation of accredited-investor status. If the offering does involve general solicitation, the issuer must rely on Rule 506(c), which limits purchasers to accredited investors only and requires the issuer to take reasonable steps to verify accredited status (typically through third-party verification by an accountant or registered broker-dealer, or by review of W-2s, tax returns, brokerage statements, or comparable documentation). There is no intermediate position. An issuer that engages in any general solicitation in connection with the offering forfeits the Rule 506(b) safe harbor and the related ability to accept non-accredited purchasers or rely on self-certification, even if no non-accredited purchaser is actually admitted to the offering.

A separate but related point: § 4(a)(2) of the Securities Act, the statutory exemption underlying Rule 506(b), has been read by the courts to prohibit general solicitation as a constitutive element of "not involving any public offering." The Ralston Purina standard requires that offerees be persons who are able to fend for themselves, and a public solicitation by definition reaches persons whose ability to do so cannot be assessed in advance. Rule 506(c), although a Reg D safe harbor under § 4(a)(2), was created by Congress's express direction in § 201(a) of the JOBS Act, which directed the SEC to lift the general-solicitation ban in Rule 506 offerings limited to accredited investors. The statutory foundation for general solicitation in private offerings is therefore narrow: it exists in Rule 506(c) by act of Congress, but not in § 4(a)(2) standing alone, and not in Rule 504 to the extent the issuer is offering in a State that prohibits general solicitation under State blue-sky law.

The accredited investor categories under Rule 501(a) include: individuals with net worth exceeding \$1 million (excluding primary residence) or income exceeding \$200,000 (\$300,000 jointly with a spouse) in each of the prior two years with a reasonable expectation of the same in the current year; entities with total assets exceeding \$5 million not formed for the purpose of acquiring the securities offered; entities whose equity owners are all accredited investors; banks, insurance companies, and certain other institutional investors; and (since the SEC's 2020 amendments) certain "knowledgeable employees" of a private fund within the meaning of Rule 3c-5 of the 1940 Act, as well as natural persons holding designated professional certifications (currently Series 7, 65, and 82) in good standing.

**Table 11.3-1 — Comparison of Securities Act Exemptions for Private Fund Offerings**

Exemption	§ 4(a)(2)	Rule 506(b)	Rule 506(c)	Rule 504
<b>Offering Size</b>	Unlimited	Unlimited	Unlimited	\$10M / 12 mos.
<b>Investor Eligibility</b>	"Able to fend for themselves" (Ralston Purina)	Unlimited accredited; up to 35 sophisticated non-accredited	Accredited investors only	No investor-eligibility limit (but State law may apply)
<b>General Solicitation</b>	Prohibited	Prohibited (Rule 502(c))	Permitted	Permitted in some States
<b>Verification of Status</b>	N/A (qualitative test)	Self-certification permitted	"Reasonable steps to verify" required	N/A
<b>NSMIA Preemption (Covered Security)</b>	No	Yes	Yes	No (State registration required)
<b>Form D Filing</b>	Not required	Required within 15 days of first sale	Required within 15 days of first sale	Required within 15 days of first sale
<b>Bad-Actor Disqualification (Rule 506(d))</b>	N/A	Applies	Applies	Separate Rule 504(b)(3)
<b>Typical Private Fund Use</b>	Backup / non-Reg D analysis	Standard for traditional private placements	Used where public marketing desired	Rare; small SPVs

**(d) Form D, Bad-Actor Disqualifications, and Integration**

A point that is often misunderstood by issuers approaching their first private offering bears emphasis. An exemption from registration under the Securities Act is an exemption from the substantive registration requirements of § 5 — the obligation to file a registration statement, to undergo SEC staff review, to produce and deliver a statutory prospectus, and to remain subject to post-effective amendment and ongoing Exchange Act reporting under § 15(d). It is not an exemption from regulation generally, and it is not an exemption from notice-filing or anti-fraud obligations. Even an offering that is fully exempt from registration is subject to a number of regulatory obligations: a notice filing on Form D with the SEC; notice filings with State securities regulators in each State of investor residence; ongoing anti-fraud liability under Rule 10b-5 and § 17(a) of the Securities Act, both of which apply to exempt offerings no less than to registered offerings; the bad-actor disqualification rule under Rule 506(d); the integration framework under Rule 152; and, in the case of pooled investment vehicles, the marketing-rule restrictions of Rule 206(4)-1 under the Advisers Act and the no-public-offering condition of the §§ 3(c)(1) and 3(c)(7) exclusions. The exemption removes the registration burden; it does not free the issuer from disclosure of the offering to regulators or from the substantive duties owed to investors.

Each Rule 506 offering requires the filing of Form D with the SEC within 15 days after the first sale of securities in the offering. The Form D discloses the identity of the issuer, the persons related to the issuer (executive officers, directors, promoters, and 10% beneficial owners), the exemption claimed (Rule 504, 506(b), or 506(c)), the type of securities offered, the offering size, the use of proceeds in summary, and (for fund offerings) the identification of the relevant § 3(c) exclusion. The filing is made electronically through the SEC's EDGAR system. The information disclosed on Form D is publicly available, and it permits the Commission staff

to monitor private offering activity in the aggregate, identify trends, and pursue enforcement against individual issuers when warranted. Most States separately require a notice filing of the same Form D (or a State-specific cover sheet accompanying the Form D) together with a filing fee. The Form D filing is administrative rather than substantive in content, but its timely filing is a condition of certain related rules (including the State notice-filing structure and certain integration safe harbors) and is itself a meaningful compliance obligation.

Rule 506(d) — the "bad actor" disqualification rule added in 2013 — disqualifies issuers from reliance on Rule 506 if certain "covered persons" (the issuer, its directors and officers, certain affiliates, persons compensated for soliciting purchasers, and 20% beneficial owners) have suffered specified disqualifying events such as criminal convictions related to securities, court injunctions, regulatory orders, or SEC cease-and-desist orders within the prescribed look-back periods. The bad-actor analysis is a routine due-diligence item in fund formation; certifications from each covered person are typically obtained at organizational closing, and the Form D itself asks the issuer to confirm that no disqualifying event has occurred.

The integration doctrine — historically a complex five-factor analysis under former Rule 502(a) — was substantially simplified by the SEC's 2020 amendments codified in Rule 152. Rule 152 supplies a general principle that offers and sales will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering complies with the requirements of the exemption being relied on, together with four non-exclusive safe harbors. The most important safe harbor in fund practice is the 30-day separation safe harbor in Rule 152(b)(1): offerings made more than 30 calendar days before commencement of any other offering, or more than 30 calendar days after termination or completion of any other offering, will not be integrated with that other offering. The current Rule 152 framework has substantially reduced integration risk in modern fund practice.

#### **11.4 Section 12(g) Holder-of-Record Constraints and State Blue-Sky Notice Filings**

Two ancillary federal and state-law constraints round out the private-placement framework. The first is Section 12(g) of the Securities Exchange Act of 1934, which imposes registration and reporting obligations on issuers whose securities are widely held, even where those securities are not listed on a national securities exchange. The threshold for § 12(g) registration is, since the JOBS Act of 2012, that the issuer have total assets exceeding \$10 million and a class of equity securities held of record by either (i) 2,000 or more persons or (ii) 500 or more persons who are not accredited investors. Once an issuer is subject to § 12(g) registration, it must file annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statements under § 14, and is subject to the insider-reporting and short-swing-profit provisions of § 16. For private investment funds, the relevance of § 12(g) is principally negative: the fund must avoid inadvertently exceeding the holder-of-record thresholds, which would trigger reporting obligations utterly inconsistent with private-fund operation. In practice, this constraint operates in tandem with the 1940 Act § 3(c)(1) 100-person limit (which is more restrictive in any event for funds relying on that exclusion) and with the 1940 Act § 3(c)(7) qualified-purchaser eligibility limit. For § 3(c)(7) funds, however, the § 12(g) holder-of-record threshold of 2,000 holders of record (or 500 non-accredited holders of record) can become a binding constraint on investor count growth, and modern fund LPAs include provisions designed to monitor and manage holder-of-record counts.

The second ancillary constraint is the State blue-sky overlay. The State "blue-sky" laws — so named because they were directed at promoters who would sell investors "the blue sky itself" — predate the federal securities regime and continue to operate alongside it. Each State has enacted a securities statute that imposes registration requirements on the offer and sale of securities within the State, anti-fraud provisions, and provisions governing the registration of broker-dealers and investment advisers. The constitutional foundation for State securities regulation was confirmed by the Supreme Court in *Hall v. Geiger-Jones Co.*, 242 U.S. 539

(1917), which sustained Ohio's blue-sky law against a Commerce Clause challenge. The National Securities Markets Improvement Act of 1996 (NSMIA) substantially preempted State registration and merit-review authority over a defined category of "covered securities" under § 18 of the Securities Act. Securities issued in transactions exempt under Rule 506 of Regulation D are covered securities, with the consequence that State registration and merit-review requirements are preempted (although the States retain authority to require notice filings, to collect fees, and to apply their anti-fraud provisions). For private investment funds relying on Rule 506(b) or Rule 506(c), the State-law overlay reduces in practice to a notice filing in each State of investor residence, accompanied by the prescribed fee, and ongoing applicability of State anti-fraud provisions.

### **11.5 Knowledgeable Employees Under Rule 3c-5**

The 100-person count under § 3(c)(1) and the qualified-purchaser requirement under § 3(c)(7) each impose constraints that, if applied strictly to every economic stakeholder of the fund, would prevent the inclusion of management-team members in the fund as investors — an outcome at odds with the long-standing market practice of GP and management co-investment alongside outside investors. Rule 3c-5 of the 1940 Act addresses this tension by excluding "knowledgeable employees" from both the § 3(c)(1) 100-person count and the § 3(c)(7) qualified-purchaser requirement, on the theory that persons with substantive involvement in the fund's investment activities do not require the protections of the 1940 Act in their capacity as investors in their own employer's fund.

Rule 3c-5(a)(4) defines a knowledgeable employee, in summary, to include two categories: (i) executive officers, directors, trustees, general partners, advisory board members, or persons serving in similar capacities of the covered company (i.e., the fund) or of an affiliated person of the covered company; and (ii) employees of the covered company or affiliated person who, in connection with their regular functions or duties, participate in the investment activities of the covered company, of other covered companies, or of investment companies that would be covered companies but for the exceptions provided by § 3(c)(1) or § 3(c)(7), provided such participation has been for at least 12 months. The 12-month service requirement may be measured by reference to a predecessor employer in some circumstances. The knowledgeable-employee status is determined as of the date of the employee's purchase of the relevant interest; subsequent loss of status (e.g., termination of employment) does not retroactively invalidate the original investment, although it may affect the employee's ability to participate in future offerings.

The practical importance of Rule 3c-5 is substantial. The exclusion permits a fund to admit, as investors alongside its outside LPs, the GP partners, the principals of the management company, the investment professionals (analysts, associates, vice presidents, principals, partners), and key operating personnel — all without those individuals counting against the 100-person § 3(c)(1) cap and without those individuals needing to satisfy the § 3(c)(7) qualified-purchaser threshold of \$5 million in investments. Whether a particular employee qualifies as "knowledgeable" turns on the substance of the employee's role: an investment-team member with portfolio responsibilities clearly qualifies; an administrative employee with no substantive investment involvement clearly does not; and intermediate cases (the head of fund operations, the chief financial officer of the management company, in-house counsel) require fact-specific analysis. A standard piece of fund-formation diligence is the production of a knowledgeable-employee list at each closing, supported by representations from each listed individual concerning the nature and duration of their investment-related duties.

### **11.6 Side Letters, Most-Favored-Nation Provisions, and Selective Disclosure**

Modern private fund offerings routinely involve the negotiation of side letters — bilateral agreements between the fund (or the GP) and individual investors that modify, supplement, or grant exceptions to the standard terms of the LPA or operating agreement. Side letters are particularly common with large institutional investors (public pension plans, sovereign wealth funds, endowments, family offices) that have the negotiating leverage to demand bespoke terms. Typical side-letter provisions include: reduced management fees or performance fees, often calibrated to the size of the investor's commitment; expanded reporting and information rights, such as additional financial statements, portfolio-level disclosures, or attribution analysis; ERISA-related representations and undertakings necessary for ERISA plan investors to satisfy the 25% threshold of the DOL plan-asset regulation; tax-related representations and undertakings necessary for U.S. tax-exempt investors (to address UBTI concerns) or non-U.S. investors (to address ECI and withholding concerns); modifications to transfer restrictions, redemption rights, or capital-call mechanics; and excused investments or opt-out rights for specific portfolio investments (e.g., investments in tobacco, firearms, or fossil fuels, where an investor's internal policies prohibit such exposure).

The principal regulatory and contractual mechanism for managing the proliferation of side letters is the most-favored-nation (MFN) clause. An MFN clause grants the holder the right to receive the benefit of any more-favorable terms granted to other investors of comparable or smaller size, subject to specified categories of carve-outs (e.g., regulatory-specific provisions are excluded). MFN clauses are commonly tiered by investor size — a \$200 million LP receives MFN against all other investors of \$100 million or less, while a \$50 million LP receives MFN only against other investors of \$25 million or less. The administrative burden of MFN compliance is significant: at each closing, the GP must compile the list of side-letter provisions, identify which investors are entitled to which MFN tiers, and elect among the available provisions on behalf of each MFN-entitled investor. The 2024 SEC Private Fund Adviser Rule (vacated, as discussed in Section 12.4 below) would have imposed substantive disclosure requirements on preferential treatment, but in the post-vacatur environment, side-letter disclosure remains primarily a contractual matter, governed by the LPA and the MFN clauses themselves rather than by mandatory regulatory disclosure.

### **11.7 Master-Feeder, Parallel Fund, and Co-Investment Architectures**

The §§ 3(c)(1) and 3(c)(7) exclusions, the Reg D safe harbors, and the various tax considerations applicable to U.S. taxable, U.S. tax-exempt, and non-U.S. investors collectively give rise to several recurring structural architectures in private fund formation. Each is designed to address a specific combination of investor type, investment strategy, and regulatory environment. The principal architectures are summarized below.

#### ***(a) Master-Feeder Structure***

The master-feeder is the dominant architecture for hedge funds, fund-of-funds, and certain other open-end private funds accepting both U.S. taxable and U.S. tax-exempt and non-U.S. investors. In a typical master-feeder, the operating fund (the "master") is a Cayman Islands exempted company or other tax-transparent offshore vehicle, which holds the portfolio investments and conducts the trading strategy. The master fund relies on § 3(c)(7) of the 1940 Act (or, less commonly, § 3(c)(1)) to avoid investment-company registration. Above the master fund sit two or more feeders: a U.S. feeder, typically a Delaware limited partnership, for U.S. taxable investors; and an offshore feeder, typically a Cayman Islands exempted company, for U.S. tax-exempt investors (to avoid UBTI) and non-U.S. investors (to avoid U.S. ECI and withholding). The U.S. and offshore feeders each conduct their own Reg D offerings to their respective investor pools, and each holds 100% of its assets in the master fund. The architecture preserves a single portfolio at the master level (avoiding the operational complexity of parallel investments by multiple funds) while permitting the tax-driven separation of investors at the feeder level.

**(b) Parallel Fund Structure**

Where the master-feeder model is not workable — typically because the investment strategy is illiquid (private equity, venture, real estate, credit) and the operational complexity of running parallel-investment programs is acceptable — the parallel-fund structure is used. In a typical parallel-fund structure, the GP manages two or more funds organized under different legal forms (a Delaware LP for U.S. taxable investors, a Cayman LP for non-U.S. and U.S. tax-exempt investors), each making the same investments at the same time in pro-rata proportions. The GP commits to causing each parallel fund to invest pro-rata in each portfolio investment, with appropriate documentary mechanics to ensure pro-rata allocation. The parallel-fund structure preserves investor segregation for tax and regulatory purposes without the master-fund complexity, but at the cost of operational duplication: every transaction must be executed simultaneously by each parallel fund, every limited-partner advisory committee must be coordinated, and every fund-level vote must be aggregated across the parallel structures.

**(c) Co-Investment Vehicles and Special-Purpose Vehicles**

Many private fund offerings also include co-investment vehicles — separate SPVs organized to hold a single portfolio investment alongside the principal fund — and special-purpose vehicles for specific transactional purposes. Co-investment vehicles typically charge reduced (or no) management and performance fees, and they admit a more limited investor base — often only the largest investors in the principal fund. Each co-investment SPV must independently satisfy the 1940 Act and Reg D analysis: it is typically organized as a Delaware LLC or LP, relies on § 3(c)(1) or § 3(c)(7), and conducts a Rule 506(b) offering to a small group of accredited investors. The 30-day integration safe harbor of Rule 152 is the practitioner's friend here: a co-investment SPV organized more than 30 days after the principal fund's offering closes can be treated as a separate offering not integrated with the principal fund's Reg D offering, simplifying the analysis.

## Section 12. Regulation of the Investment Adviser and Fund Fiduciary

The Investment Advisers Act of 1940 governs persons in the business of providing investment advice for compensation. Its central operative provision is § 203, which requires registration with the SEC of any "investment adviser" (a defined term under § 202(a)(11)) unless an exclusion from the definition or an exemption from registration applies. The Act's 2010 amendments by Title IV of Dodd-Frank fundamentally restructured the regulatory framework applicable to advisers to private funds: the prior "private adviser exemption" of former § 203(b)(3) (which exempted advisers with fewer than fifteen clients) was repealed, and most fund advisers either register with the SEC under § 203 or rely upon one of the new "exempt reporting adviser" exemptions described below.

### 12.1 The Statutory Trigger for Investment Adviser Status

Section 202(a)(11) defines an investment adviser as any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities. The three operative elements — (i) for compensation, (ii) in the business of advising others, and (iii) as to securities — must each be satisfied. The SEC's interpretive guidance under Release No. IA-1092 (1987) elaborates each element, and the "in the business" element in particular has been the subject of substantial Commission no-action letter and enforcement guidance.

Several statutory exclusions remove specified categories of persons from the definition: banks and bank holding companies (§ 202(a)(11)(A)); lawyers, accountants, engineers, and teachers giving incidental advice (§ 202(a)(11)(B)); broker-dealers receiving no special compensation for advice (§ 202(a)(11)(C)); publishers of bona fide newspapers and other publications (§ 202(a)(11)(D)); and family offices satisfying the requirements of Rule 202(a)(11)(G)-1. Within the meaning of the operative definition, however, the manager of a private investment fund is squarely an investment adviser: it is engaged in the business of advising others (the fund and, derivatively, the fund's investors) for compensation as to investments in securities.

## 12.2 Regulatory Thresholds: Federal SEC Registration vs. State-Level Blue Sky Oversight

Once a person is an investment adviser within the meaning of § 202(a)(11), the next question is whether registration is required and, if so, where. Dodd-Frank reallocated regulatory jurisdiction between the SEC and the States by amending § 203A. The current framework distinguishes three categories based on regulatory assets under management ("RAUM"), with several special categories overlaid:

- **"Small advisers" with RAUM below \$25 million.** State-registered; SEC registration generally prohibited.
- **"Mid-sized advisers" with RAUM between \$25 million and \$100 million.** Generally State-registered in the State of their principal office and place of business, unless the adviser is either (i) not subject to examination by that State (rare; New York and Wyoming) or (ii) required to register in 15 or more States.
- **Large advisers with RAUM of \$100 million or more.** SEC-registered.
- **Advisers solely to private funds with RAUM of \$150 million or more.** SEC-registered regardless of the State allocation rules. (Below the \$150 million threshold, such advisers are exempt reporting advisers under § 203(m); see Section 12.3 below.)
- **Advisers to registered investment companies.** Always SEC-registered.
- **Non-U.S. advisers.** Subject to SEC jurisdiction to the extent of their U.S. activities; the foreign private adviser exemption (Section 12.3 below) is narrowly available.

## 12.3 The Exempt Reporting Adviser (ERA) Pathway: Venture Capital and Private Fund Adviser Safe Harbors

Even where an adviser meets the threshold for SEC registration, three categorical exemptions added by Dodd-Frank are of central importance for fund managers. The first two — the private fund adviser exemption and the venture capital fund adviser exemption — exempt the adviser from registration but require it to file an abbreviated public report on Form ADV. Advisers relying on these exemptions are known as "exempt reporting advisers" (ERAs). The third — the foreign private adviser exemption — is a complete exemption from both registration and reporting but is narrowly drawn and rarely available to substantial non-U.S. fund managers.

**Private fund adviser exemption (§ 203(m); Rule 203(m)-1).** Exempts any adviser that acts solely as an adviser to qualifying private funds (3(c)(1) or 3(c)(7) funds) and that has aggregate RAUM attributable to private funds in the United States of less than \$150 million. The exemption is lost if the adviser takes on any non-private-fund client (e.g., a separately managed account for a single investor) or if RAUM exceeds the threshold.

**Venture capital fund adviser exemption (§ 203(l); Rule 203(l)-1).** Exempts any adviser that acts solely as an adviser to one or more "venture capital funds" within the meaning of Rule 203(l)-1. A "venture capital fund" must, in summary, (i) represent itself as pursuing a venture capital strategy; (ii) hold no more than 20% of its

capital in non-qualifying investments (largely limited to direct equity investments in qualifying portfolio companies); (iii) not borrow more than 15% of its capital and only on a short-term basis; (iv) not offer redemption rights to investors except in extraordinary circumstances; and (v) not be registered under the 1940 Act or a BDC. No RAUM cap applies.

**Foreign private adviser exemption (§ 202(a)(30)).** Exempts a non-U.S. adviser that (i) has no place of business in the United States; (ii) has fewer than 15 U.S. clients and U.S. investors in private funds combined; (iii) has aggregate U.S. AUM of less than \$25 million; and (iv) does not hold itself out to the U.S. public as an investment adviser. The 15-client/investor cap and the \$25 million AUM cap make the exemption unavailable to most non-U.S. managers with meaningful U.S. business.

ERAs (those relying on the private fund adviser or venture capital fund adviser exemptions) are required to file public Form ADV Parts 1A and a limited subset of items, to update those filings annually and upon material changes, and to comply with certain books-and-records and anti-fraud provisions of the Advisers Act — including § 206 — but are not subject to the full compliance regime applicable to registered advisers. The operational and cost differential between ERA status and full registration is substantial; many emerging managers structure their RAUM and client base specifically to remain within the ERA exemptions.

**Table 12.3-1 — Investment Adviser Registration Status by Adviser Type**

Adviser category	Threshold / criteria	Registration status	Filing & compliance
<b>Small Adviser</b>	RAUM < \$25M.	State-registered; SEC registration prohibited.	State Form ADV; State compliance rules apply.
<b>Mid-Sized Adviser</b>	RAUM \$25M–\$100M (and either subject to State exam or filing in <15 States).	State-registered.	State Form ADV; State compliance rules apply.
<b>Large Adviser</b>	RAUM ≥ \$100M.	SEC-registered.	Full Form ADV (Parts 1, 2A, 2B); full Advisers Act compliance; SEC examination.
<b>Private Fund Adviser Exempt (§ 203(m))</b>	Adviser solely to qualifying private funds; U.S. RAUM < \$150M.	ERA; abbreviated Form ADV filed.	Form ADV Part 1A (subset); annual updates; books and records; § 206 anti-fraud; political-contributions rule.
<b>VC Fund Adviser Exempt (§ 203(l))</b>	Adviser solely to one or more "venture capital funds" under Rule 203(l)-1; no RAUM cap.	ERA.	Same as private fund adviser ERAs.
<b>Foreign Private Adviser (§ 202(a)(30))</b>	No U.S. place of business; <15 U.S. clients/investors; U.S. RAUM < \$25M; no holding out.	Fully exempt; no Form ADV.	Anti-fraud only.
<b>Private Fund Adviser ≥ \$150M</b>	Adviser to private funds with RAUM ≥ \$150M.	SEC-registered (regardless of State rules).	Full registered adviser compliance regime.
<b>RIC Adviser</b>	Adviser to one or more registered	SEC-registered.	Full registered adviser

Adviser category	Threshold / criteria	Registration status	Filing & compliance
	investment companies.		compliance plus 1940 Act § 15 contract requirements.
<b>Family Office</b>	Satisfies Rule 202(a)(11)(G)-1 (single-family clients; family ownership; no holding out).	Excluded from the definition; no registration or reporting.	None under the Advisers Act.

## 12.4 Substantive Compliance Obligations: Fiduciary Duties, Form ADV Disclosures, and Rule 206(4)-2 Custody Mandates

A registered investment adviser is subject to a comprehensive set of substantive conduct rules. Section 206 of the Advisers Act imposes the foundational anti-fraud provisions, which apply to both registered and unregistered advisers (including ERAs) and impose a fiduciary duty on the adviser-client relationship. The Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), held that § 206 imposes "an affirmative obligation of utmost good faith, and full and fair disclosure of all material facts" and that the adviser is a fiduciary to its clients — a foundational doctrinal principle subsequently elaborated in numerous SEC enforcement actions and in the 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Release No. IA-5248).

Beyond § 206, the principal conduct rules applicable to registered advisers include the following:

- **Custody rule (Rule 206(4)-2).** Detailed safekeeping requirements applicable to advisers that have "custody" of client assets, including the use of qualified custodians, delivery of account statements, and (for many private fund advisers) the annual independent audit and distribution of audited financial statements within 120 days of fiscal year-end. The custody rule is the source of much of the operational compliance burden of fund management.
- **Marketing rule (Rule 206(4)-1, revised effective November 2022).** Governs the use of testimonials, endorsements, third-party ratings, and performance presentations, including the requirements applicable to hypothetical performance, related performance, and net-of-fees presentation.
- **Compliance rule (Rule 206(4)-7).** Requires written compliance policies and procedures reasonably designed to prevent violation of the Advisers Act, designation of a chief compliance officer, and annual review of the compliance program.
- **Code of ethics rule (Rule 204A-1).** Requires adoption of a code of ethics addressing personal securities trading by access persons, holdings and transactions reports, and pre-clearance of certain investments.
- **Pay-to-play rule (Rule 206(4)-5).** Restricts the ability of an adviser to provide advisory services for compensation to government clients within two years after a political contribution by the adviser or its covered associates to certain elected officials.
- **Form ADV delivery (Rule 204-3).** Requires delivery of Form ADV Part 2A (the brochure) to each client at the inception of the advisory relationship and annual delivery thereafter (or summary updates with offer to deliver).
- **Recordkeeping rule (Rule 204-2).** Specifies the books and records required to be maintained for prescribed periods (generally five years, with the first two on-site).

- **Proxy voting rule (Rule 206(4)-6).** Requires written policies and procedures for the voting of client securities and disclosure of the policies and of voting records.

In February 2024, the SEC adopted the so-called "Private Fund Adviser Rule" (Rule 211(h)-1 and related provisions), imposing significant new obligations on private fund advisers including quarterly statements, annual audits, prohibited activities provisions, and preferential-treatment disclosure requirements. The Fifth Circuit, in *National Association of Private Fund Managers v. SEC*, 103 F.4th 1097 (5th Cir. 2024), vacated the Private Fund Adviser Rule in its entirety, holding that the SEC had exceeded its statutory authority. The Commission did not seek Supreme Court review, and as of the date of this Guide the Rule is not in effect. The episode illustrates both the SEC's continuing regulatory ambitions in the private fund space and the increasingly active role of the federal courts in policing the boundaries of administrative authority following *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024) (overruling Chevron deference).

## Practitioner's Synthesis I: Worked Operational Examples

The interlocking architecture of Parts I through IV is best understood by working through specific factual scenarios in which the multiple regimes interact. The following examples are stylized; real engagements involve additional facts that may alter the analysis. Each scenario traces the relevant share or fund interest across each operative regulatory regime, identifying which test applies, what the result is, and how the regimes interact with each other.

### Example A: Same Shares, Five Different Classifications

A privately held Delaware corporation has Class A voting common (100 shares, held by founders) and Class B nonvoting common (900 shares, held by employees and outside investors). The substantive rights to dividends and liquidation are identical. The corporation has elected S-corp status. The Class B is uncertificated; the Class A was originally certificated and remains so.

- State corporate law (Sections 1, 2): two classes of stock, validly authorized by the certificate. The Class A/Class B distinction is established at the class level (voting differentiation) and was created by the certificate of incorporation under DGCL § 151(a).
- Stock ledger (Section 4): if Delaware-organized, ledger can be cloud-hosted under DGCL § 224; if New York, must be in-state per NY BCL § 624(a). The uncertificated Class B requires § 151(f) post-issuance notice; the certificated Class A is covered by the legend on the certificate itself.
- UCC Article 8 (Sections 5, 6): the certificated Class A is reachable by physical seizure of the certificate under § 8-112(a); the uncertificated Class B is reachable by service on the issuer's chief executive office under § 8-112(b). Different sheriffs in different procedural postures may be required for the two classes.
- Contract construction (Section 3): voting/nonvoting distinction is clearly stated; no construction issue arises.
- Subchapter S (Section 7): one class for tax purposes — voting differences are explicitly disregarded under Treas. Reg. § 1.1361-1(l)(1). The corporation accordingly remains an eligible S corporation.
- Federal securities law disclosure (Section 8): if a registration statement is filed (e.g., on a Form S-1 for an IPO), both classes must be disclosed under Item 202 of Reg S-K with their respective dividend, voting, liquidation, and other rights.

- Exchange listing (Section 9): if the corporation later seeks to list its Class A on the NYSE, the Class B structure may need to be revisited under § 313 / Rule 5640; an IPO carve-out is permissible, and a sunset provision should be considered to address ISS/Glass Lewis voting policies.
- Securities Act exemption (Section 11.3): issuances to employees and outside investors must rely on Rule 506(b) (most likely) or another available exemption (e.g., Rule 701 for compensatory issuances under an equity-compensation plan); Form D filing required.

### **Example B: Series A Venture Preferred Round**

A Delaware C corporation issues Series A Preferred to a venture fund: \$5M aggregate, 1x non-participating preference, weighted-average antidilution, board observation rights, customary protective provisions covering charter amendments adverse to the Series A, authorization of senior or pari passu securities, and Deemed Liquidation Events. The Series A is uncertificated and is issued pursuant to a Certificate of Designation filed with the Delaware Secretary of State.

- State law (Section 2): the Series A is created at the series level under DGCL § 151(g) blank-check authority. The Certificate of Designation operates as an effective amendment to the charter. The 1x non-participating preference, weighted-average antidilution, and protective provisions are all set at the series level; the par value, no-par status, and basic preferred-vs-common categorization were set at the class level in the original certificate.
- Tax (Section 7): company remains a C corporation; § 306 stock concerns do not arise (Series A is preferred received for cash, not as a stock dividend on common). The investor is a venture fund (a Delaware LP), which holds the Series A through its limited-partnership structure; flow-through tax treatment to the fund's LPs applies.
- Contract construction (Sections 3.1–3.3): the protective provisions must be drafted with explicit enumeration of all matters requiring Series A consent; absent triggers will not be implied (Rothschild line). Note: in the example, the protective provisions cover charter amendments adverse to the Series A, but if the company contemplates a recapitalization through a holding-company merger that does not technically amend the existing charter, the Series A vote may not attach unless the protective provisions expressly cover "any action having the effect of any of the foregoing."
- Securities offering (Section 11.3): standard Rule 506(b) private placement; investor (VC fund) is accredited; Form D filed within 15 days of closing; the offering does not involve general solicitation and the investor self-certifies accredited status.
- Advisers Act (Section 12): VC fund's manager may rely on § 203(l) VC fund adviser exemption (assuming Rule 203(l)-1 criteria are satisfied — the fund must hold no more than 20% in non-qualifying investments and must satisfy the other criteria) or, if not, on § 203(m) if RAUM < \$150M.
- Settlement and creditor mechanics (Sections 4, 5, 6): the Series A is uncertificated; transfer is by book entry on the company's stock ledger; creditor seizure (if the VC fund's interest in the Series A were attached) would proceed by service on the issuer under UCC § 8-112(b), with the corresponding right-of-first-refusal protections in the LPA limiting the practical value of the seized position.

### **Example C: Setting Up a U.S. Hedge Fund — § 3(c)(1) or § 3(c)(7)?**

An emerging hedge fund manager is forming a Delaware limited partnership to manage a long-short equity strategy. Initial target capital: \$25M from 30 high-net-worth investors, with plans to grow to \$200M and 60–80

investors over three years. Investor minimum: \$250,000. The manager is an LLC owned by two principals, neither of whom previously operated a registered investment adviser.

- § 3(c)(1) is the natural choice: investor minimum is well below the \$5M qualified-purchaser threshold, and the 100-person count comfortably accommodates the contemplated investor base (with headroom against the operative target of 95 beneficial owners discussed in Section 11.1). Rule 3c-5 knowledgeable-employee carve-outs allow the two principals and any senior investment-team members to invest alongside outside LPs without counting against the 100-person cap.
- Securities offering (Section 11.3): Rule 506(b). Investors are accredited (verified by self-certification questionnaire); no general solicitation. PPM, LPA, and subscription agreement prepared; Form D filed within 15 days of first sale; State blue-sky notice filings in each State of investor residence.
- Adviser status (Section 12.2): at \$25M RAUM, manager is State-registered (Small Adviser; SEC registration prohibited under § 203A). As RAUM crosses \$100M, transitions to SEC large-adviser registration — unless the manager remains within the § 203(m) private fund adviser exemption (RAUM < \$150M, solely private fund clients), in which case ERA status applies until \$150M is crossed.
- Blue sky (Section 11.4): notice filings in each State of investor residence; State adviser registration in adviser's home State pending SEC threshold.
- § 12(g) (Section 11.4): not binding given the contemplated investor count (well below the 2,000 holder-of-record threshold and the 500 non-accredited subcap), but transfer restrictions in the LPA preserve the structure against unexpected growth.
- Side letters (Section 11.6): the manager should anticipate that the larger institutional investors will demand side letters granting fee reductions, additional reporting rights, and possibly MFN protections. The MFN administration burden should be built into the operations plan from the outset.

### **Example D: Setting Up a U.S. Venture Capital Fund**

A two-partner team is forming a \$100M VC Fund I as a Delaware limited partnership, with a 10-year term, no investor redemption rights, primary investments in Series Seed and Series A rounds of U.S. portfolio companies, and a 20% carry. The fund's investor base will be a mix of HNW individuals, family offices, and small institutions; the average commitment is \$2M, and the largest commitment is \$10M.

- § 3(c)(1) or § 3(c)(7) (Section 11): the fund itself relies on one of these exclusions to avoid 1940 Act investment company registration. § 3(c)(1) is typical for a first fund accepting both qualified-purchaser and non-QP accredited investors; the 100-person count accommodates ~50 investor commitments comfortably.
- Securities offering (Section 11.3): Rule 506(b); investor questionnaire collects accredited-investor certifications; Form D filed.
- Adviser status (Section 12.3): at \$100M RAUM, manager could be SEC-registered (Large Adviser) or, if the fund qualifies as a venture capital fund under Rule 203(l)-1, ERA under § 203(l) — almost always preferred because of the reduced compliance burden. The Rule 203(l)-1 criteria must be satisfied and monitored: VC strategy representation; no more than 20% in non-qualifying investments (secondary purchases, fund-of-funds, etc.); no more than 15% borrowings, and only short-term; no investor redemption rights except in extraordinary circumstances; and no 1940 Act registration.

- Operating constraint: 20% of capital may be invested in secondary purchases, fund-of-funds positions, or other non-qualifying investments without forfeiting VC-fund-adviser status; track this in fund operations and produce quarterly compliance certifications.
- Portfolio-company shares (Sections 4, 8.4): the fund's holdings of portfolio-company Series Seed and Series A Preferred are restricted securities. On portfolio-company IPOs, Rule 144 holding periods and exchange lock-ups will constrain the timing of distribution-in-kind events to LPs.

### **Example E: Real Estate Equity Fund**

A real estate sponsor is forming a private fund to acquire and operate apartment buildings in the Southeastern United States. Target capital: \$75M; 30 accredited investors; 7-year fund life. The fund will acquire properties through wholly-owned subsidiaries and may use modest property-level mortgage financing.

- 1940 Act (Section 11.2): fund relies on the SEC's longstanding interpretive position that direct real estate ownership is not the business of investing in securities; § 3(c)(1) or § 3(c)(7) is not even reached. The structural cleanliness of direct real estate ownership avoids 1940 Act analysis at the entry point. If the fund were instead investing in mortgages or other real-estate-secured debt, the § 3(c)(5)(C) exclusion would be the analytical home.
- Securities offering (Section 11.3): Rule 506(b); investor questionnaire for accredited status; Form D filed. LP interests in the fund are securities (Section 10.1(c)) even though the underlying real property is not.
- Adviser status (Section 12.2): depends on adviser's overall business; if manager solely advises real estate funds, the manager may qualify for the § 203(m) private fund adviser exemption (under \$150M) or be SEC-registered (over \$150M). The § 203(l) VC exemption is not available because real estate funds do not satisfy the venture-capital-fund definition.
- Real estate operating partnership and REIT structures introduce additional tax considerations (Subchapter M REIT qualification) not addressed in this Guide.

### **Example F: Master-Feeder Structure for International Investors**

A hedge fund manager with U.S. taxable, U.S. tax-exempt, and non-U.S. investors typically organizes the master-feeder structure described in Section 11.7(a): a Cayman Islands master fund relying on § 3(c)(7), a Delaware LP feeder for U.S. taxable investors, and a Cayman Islands feeder for U.S. tax-exempt and non-U.S. investors. Each feeder relies on § 3(c)(7) or § 3(c)(1) depending on investor mix. Each feeder conducts a Rule 506(b) (or 506(c)) offering for its investor class. The structure addresses tax efficiency (avoiding UBTI for U.S. tax-exempt investors via the offshore feeder; avoiding PFIC issues for U.S. taxable investors via the master) while preserving 1940 Act and Securities Act compliance through the master-feeder architecture. The adviser is SEC-registered (RAUM > \$150M and likely > \$100M independently), and the adviser's Form ADV discloses the master-feeder relationships and the affiliated-person relationships at the GP and management-company levels.

## **Practitioner's Synthesis II: Diagnostic Checklist**

The following checklist is offered as a starting point for diagnosing a share-classification, ledger, transfer, or securities-regulation question in U.S. corporate practice. It is organized by Part and tracks the analytical sequence developed in the preceding Sections.

## Part I — Foundations

- Identify which body of law is asking the question (state corporate, ledger, UCC, contract construction, federal tax, federal securities, exchange listing, 1940 Act, Advisers Act) before reaching for an answer (Section 1.1).
- Inventory the corporation's authorized, issued, outstanding, treasury, and reserved shares (Section 1.2). Confirm that outstanding shares = issued – treasury and reconcile against the cap table.
- For each class and series, identify whether the share is common or preferred and, if preferred, enumerate the specific economic preferences (dividend priority, liquidation priority, redemption, conversion, antidilution) plainly set forth in the certificate (Section 1.4).
- Confirm whether each class was established by the certificate of incorporation (mandatory) and whether each series was established by certificate of designation under blank-check authority (Section 2).
- Identify any obsolete or fully-redeemed series and recycle them under DGCL § 151(g) to preserve charter clarity (Section 2.4).
- For contract-construction disputes, apply the Rothschild strict-construction principle and the presumption of commonality (Sections 3.1, 3.2); audit the certificate for the standard drafting failures catalogued in Section 3.3 (cumulative dividends, participating preferred, protective-vote scope, Deemed Liquidation Events, antidilution mechanics).

## Part II — Operational Realities

- Examine the stock ledger for state-specific compliance — Delaware (DGCL § 224, flexible) or New York (NY BCL § 624(a), in-state location mandate) (Section 4).
- For uncertificated shares, confirm § 151(f) or § 508(f) post-issuance notices have been sent (Section 4.4).
- If shares are publicly traded, map the indirect-holding chain (Cede & Co. / DTC / DTC participant / broker-dealer / customer) and identify the operative UCC Article 8 status of each layer (Sections 5.1, 5.2).
- Confirm settlement and clearance procedures conform to NSCC/DTC requirements and the applicable settlement cycle (currently T+1) (Section 5.3).
- For creditor-seizure scenarios, identify the holding pattern (certificated, direct uncertificated, security entitlement) and apply the corresponding subsection of UCC § 8-112 (Section 6.2).
- For close-corporation transfer restrictions, confirm DGCL § 202 compliance and conspicuous-notice display (Section 6.4).
- For LLC or LP equity interests, recognize that the charging-order regime — not UCC § 8-112 — is the operative creditor remedy, and assess single-member-LLC exclusivity issues under the applicable state's statute (Section 6.5).

## Part III — Regulatory Regimes

- For S corporations: apply the Treas. Reg. § 1.1361-1(l) economic-rights-only test; confirm the buy-sell safe harbor under § 1.1361-1(l)(2)(iii) if applicable (Sections 7.1, 7.2).
- For C corporations distributing preferred to common holders: analyze § 306 "section 306 stock" treatment and plan dispositions to qualify for available exceptions (Section 7.3).

- For federal securities classification: apply Reg S-K Item 202 disclosure requirements and Rule 12g5-1 held-of-record methodology (Sections 8.1, 8.2).
- For restricted securities (received in private offerings), assess Rule 144 availability and structure exit timing accordingly (Section 8.4).
- For exchange-listed issuers: confirm NYSE § 313 / Nasdaq Rule 5640 / sunset provisions are addressed (Section 9).

#### **Part IV — Pooled Investment Vehicles**

- Confirm whether the instrument being offered is a security under § 2(a)(1) of the Securities Act, the Howey test, and (for notes) the Reves family-resemblance test (Section 10.1). If LLC or GP interests are involved, apply *Williamson v. Tucker*.
- Determine whether the issuer meets the § 3(a) definition of an investment company under the 1940 Act (primarily engaged; 40% test; Rule 3a-1 safe harbor) (Section 10.2).
- If the issuer is an investment company, identify the applicable § 3(c) exclusion — most commonly § 3(c)(1) or § 3(c)(7), or in real-estate-credit contexts § 3(c)(5)(C) (Section 11).
- Monitor the § 3(c)(1) 100-person count or the § 3(c)(7) qualified-purchaser eligibility of every investor throughout the fund's life; apply the Rule 3c-5 knowledgeable-employee carve-out for investment-team members (Sections 11.1, 11.5).
- Choose the appropriate Securities Act exemption: Rule 506(b) (most common) or Rule 506(c) (general solicitation permitted; accredited-only with verification) (Section 11.3).
- If Rule 506(b), confirm the absence of general solicitation; document the substantive pre-existing relationship with each offeree.
- If Rule 506(c), implement reasonable-verification procedures for accredited status; assess interaction with § 3(c)(1)/(7) no-public-offering condition.
- File Form D with the SEC within 15 days of first sale; file State notice filings in each State of investor residence.
- Conduct Rule 506(d) bad-actor due diligence on all covered persons; obtain certifications at the initial closing and update for each subsequent closing.
- Apply the Rule 152 integration framework; rely on the 30-day separation safe harbor where applicable.
- Document side letters and operate MFN administration on each closing; maintain a side-letter matrix for ongoing compliance (Section 11.6).
- Select the appropriate fund architecture (master-feeder, parallel-fund, co-investment SPVs) based on investor mix, strategy, and tax considerations (Section 11.7).
- Determine adviser registration status under § 203A: Small (state); Mid-Sized (state); Large (SEC); Private Fund Adviser ≥ \$150M (SEC) (Section 12.2).
- Assess ERA exemptions: § 203(m) private fund adviser (RAUM < \$150M); § 203(l) VC fund adviser (no RAUM cap; meet Rule 203(l)-1 criteria); § 202(a)(30) foreign private adviser (narrow) (Section 12.3).
- For registered advisers, implement the substantive conduct rules — custody (Rule 206(4)-2), marketing (Rule 206(4)-1), compliance (Rule 206(4)-7), code of ethics (Rule 204A-1), pay-to-play (Rule 206(4)-5),

Form ADV delivery (Rule 204-3), recordkeeping (Rule 204-2), and proxy voting (Rule 206(4)-6) (Section 12.4).

- Monitor § 12(g) holder-of-record thresholds (2,000 / 500 non-accredited); maintain transfer restrictions accordingly (Section 11.4).
- File State blue-sky notice filings under NSMIA-preempted covered-security framework; register adviser at State level where required (Section 11.4).

## Conclusion

This Guide has traced the lifecycle of a share of a U.S. corporation across four logical levels of generality. Part I established the universal foundation: what a share is as a creature of state corporate law, the capital statuses it may occupy, the class/series architecture by which corporations differentiate among their equity holders, and the contractual rule of construction by which Delaware courts resolve drafting ambiguities. Part II turned to operational realities: the evidentiary apparatus of the corporate ledger, the indirect-holding system of the public markets through DTC and Cede & Co. under UCC Article 8, and the creditor-seizure mechanics of UCC § 8-112 across the three holding patterns. Part III layered on the multi-regime regulatory framework: Subchapter S of the Internal Revenue Code, the federal securities laws as a classification and disclosure overlay, and stock-exchange listing standards. Part IV applied the foundational concepts to the ultimate particularity — regulation of pooled investment vehicles — with deliberate emphasis on private placement, which is the dominant pathway for the pooled investment structures that constitute most of contemporary U.S. fund practice.

The central methodological lesson of the Guide is that no single classification of a share is universally correct. Each regulatory regime asks its own question and supplies its own answer. The same shares may be one class for Subchapter S purposes, two for state corporate-law purposes, and a third for federal securities disclosure purposes, all simultaneously. The same shares may be reachable by a creditor through physical seizure, service on the issuer, or garnishment of an intermediary, depending on the holding pattern. The same fund interests may be securities under the Securities Act but not subject to registration under the 1940 Act, may be marketed through Rule 506(b) without general solicitation, and may be managed by an adviser exempt from registration under § 203(m) — all simultaneously. The practitioner who understands the matrix is equipped to advise; the practitioner who reaches for a single answer is, sooner or later, surprised.

For the practitioner whose clients are forming private investment vehicles — the dominant use case in contemporary practice — the four-step framework set out in Part IV supplies the structural roadmap. First, confirm that the instrument is a security under *Howey* and *Reves*. Second, confirm that the issuer either falls outside the § 3(a) definition of an investment company or qualifies for a § 3(c) exclusion (most commonly § 3(c)(1) or § 3(c)(7)). Third, structure the offering to qualify for a Rule 506(b) (or, where general solicitation is desired, Rule 506(c)) exemption, with attention to Form D, bad-actor disqualification, integration, and State blue-sky notice filings. Fourth, assess the manager's status under the Advisers Act and determine whether full SEC registration is required or whether one of the ERA exemptions (§ 203(m) or § 203(l)) is available. The four steps are independent, the failure of any one is structurally fatal, and the analysis must be revisited as the fund evolves. The integrated treatment that this Guide aims to provide is, accordingly, the only treatment adequate to the complexity of the subject.

**Caveat.** *This Guide is a general overview of U.S. legal principles governing shares of U.S. companies and the securities regulation of U.S. investment vehicles. It does not constitute legal advice and should not be relied upon as such. The application of any particular rule depends on the specific facts and circumstances of the engagement, and recent legislative, regulatory, judicial, or administrative developments may have altered the analysis presented. Any reader confronting a real-world engagement should consult qualified counsel admitted to practice in the relevant jurisdictions.*

## **PART V**

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### **PART V — CHOICE OF ENTITY FOR PRIVATE AND POOLED INVESTMENT VEHICLES**

The four Parts above analyze the share itself — its rights, its evidence, its regulatory classifications, and its use in pooled vehicles. This concluding Part supplies the entity-selection and taxation framework that surrounds those shares and fund interests: the law of business entities, the four federal income-tax sub-regimes (Subchapters C, K, S, and M), the hedge-fund trading-activity tax rules, the architecture of multi-entity investment structures, and the securities-regulation overlay restated in entity-selection terms. It is reproduced here, with its own internal numbering (I–XII), as an integrated companion treatise so that the practitioner has, in a single document, both the share-level and the entity-level analysis required to design and operate a U.S. investment vehicle.

## I. PRELIMINARY STATEMENT AND SCOPE OF MEMORANDUM

This memorandum is a comprehensive comparative treatment of the principal business-entity forms employed in the design and operation of private and pooled investment vehicles in the United States.

It addresses the four formal entity types — the corporation (whether organized under a State **business corporation** law or as a statutory trust or association taxable as a corporation), the **general partnership** ("GP"), the **limited partnership** ("LP"), and the **limited liability company** ("LLC") — together with their treatment under the four federal income tax sub-regimes that govern them (Subchapters C, K, S, and M of Chapter 1 of Subtitle A of the **Internal Revenue Code of 1986**, as amended; references herein to the "Code" or "I.R.C." are to that statute).

The memorandum sits these tax considerations against the regulatory backdrop of the federal securities laws — the **Securities Act of 1933**, the **Securities Exchange Act of 1934**, the **Investment Company Act of 1940** (the "1940 Act"), and the **Investment Advisers Act of 1940** (the "Advisers Act").

It also addresses the specialized trading-activity tax rules that hedge funds and active trading vehicles must navigate: the **wash-sale** rule of § 1091, the **straddle** rules of § 1092, the § 1256 contracts regime with its 60/40 treatment, the constructive-sale provisions of § 1259, and the elective mark-to-market regime of § 475(f).

The memorandum is organized as a treatise rather than as a transactional opinion. Part II surveys the law of business entities itself. Part III examines the federal income tax treatment, working through each of the four sub-regimes (**Subchapter C** for ordinary corporations, **Subchapter S** for the closely-held **pass-through** corporation, **Subchapter K** for partnerships and partnership-taxed LLCs, and **Subchapter M** for regulated investment companies ("RICs") and **real estate investment trusts** ("REITs")).

Part VIII addresses the hedge-fund-specific trading-activity rules and ancillary topics including **management fee waivers**, disguised-payment-for-services analysis under § 707(a)(2)(A), and the state-and-local-tax workaround known as the **passthrough entity tax** ("PTET") election. Part IX addresses the federal securities laws.

Parts IV, V, and VI synthesize the doctrinal material into three propositions about practical entity selection. The limited partnership has, with overwhelming consistency, become the preferred form for private investment funds (Part IV).

The corporation, though disfavored as a primary fund vehicle, retains primacy in several specific roles — most significantly as the sponsor or management company, as a "blocker" against **unrelated business taxable income** or **effectively connected income**, and, in its Subchapter M form, as the only workable vehicle for retail-distributed pooled investments (Part V).

The limited liability company occupies the institutional ground between the two — universally chosen for **special-purpose vehicles** ("SPVs"), holding companies, single-asset investment vehicles, and the general-partner and management-company entities that sit alongside fund LPs (Part VI).

Part VII develops the practical thesis central to fund formation: a sophisticated investment vehicle is rarely a single entity, but is rather a structured assembly of multiple entities, each chosen for its comparative advantage in solving a discrete legal, tax, regulatory, or commercial problem.

The typical institutional-quality private fund involves not fewer than four distinct entities — the fund vehicle (LP), the general partner (LLC), the management company (LLC), and the sponsor/parent (LLC or corporation) — with additional entities (offshore feeders, blockers, parallel funds, alternative investment vehicles, and SPVs) added as the strategy and investor base require. The memorandum maps that interplay in detail, with reference to specific structural archetypes (the **master-feeder**, the **parallel-fund**, the **UPREIT**, the BDC, and the carried-interest vehicle).

Part X consolidates the principal distinctions in tabular form, Part XI states the conclusions, and Part XII provides selected references. Citations to judicial decisions appear in the conventional form, with party names italicized. This memorandum is provided for informational and analytical purposes only; it does not constitute legal or tax advice and may not be relied upon as such. Any specific transaction or planning decision should be discussed with qualified counsel and tax advisors.

## II. FOUNDATIONS OF BUSINESS ENTITY LAW

Before the federal tax characterization is reached, every business entity is, in the first instance, a creature of State law — formed under, governed by, and dissolved pursuant to the law of a single State. The federal tax regime is in this sense parasitic upon State entity law: it accepts the State-law form as a starting point and overlays a federal tax classification (under the entity-classification regulations promulgated under Code § 7701, the **check-the-box regulations** of 1996, codified at Treasury Regulation §§ 301.7701-1 to -3).

The choice of State of formation, the choice of entity form within that State, and the negotiated terms of the entity's governing instrument together determine the non-tax attributes — liability exposure, management rights, transferability, fiduciary duty, dissolution, and the rest — that frequently are the principal drivers of entity selection. The federal tax overlay, important as it is, follows rather than leads.

The discussion in this Part proceeds form-by-form. Subpart II.A addresses the corporation; Subpart II.B the general partnership; Subpart II.C the limited partnership; Subpart II.D the limited liability company. Subpart II.E synthesizes the comparison along the principal axes of distinction.

Delaware and New York are the principal reference jurisdictions — both because each is heavily used in fund and investment structuring and because their statutes represent the two principal modern statutory traditions: the **Delaware General Corporation Law** ("DGCL"), **Delaware Limited Liability Company Act** ("DLLCA"), and **Delaware Revised Uniform Limited Partnership Act** ("DRULPA") on the one hand, and the **New York Business Corporation Law** ("BCL"), **Limited Liability Company Law** ("LLCL"), and **Partnership Law** on the other.

### A. The Corporation

The corporation is the oldest and most institutionally familiar of the four forms. It is created by a State filing — a Certificate of Incorporation in Delaware, a Certificate of Incorporation in New York under BCL § 402 — and exists thereafter as a separate juridical person, distinct from its shareholders, with perpetual duration unless its charter provides otherwise.

Its defining structural attributes are five: separate legal personality; limited liability of the shareholders; centralized management vested in a board of directors elected by the shareholders; free transferability of shares; and continuity of life independent of the identity of the shareholders.

Shareholders of a corporation are, with negligible exceptions, not personally liable for the obligations of the corporation. The veil of limited liability may be subject to **piercing the corporate veil** under

traditional alter-ego, undercapitalization, or fraud doctrines, but the threshold for piercing under Delaware and New York law is meaningful.

The Delaware Court of Chancery has reiterated, in cases such as *Wallace ex rel. Cencom Cable Income Partners II, L.P. v. Wood*, 752 A.2d 1175 (Del. Ch. 1999) and a long line of subsequent decisions, that veil-piercing is "an exception of last resort" that requires both an abuse of the corporate form and a result that would otherwise be inequitable. The New York Court of Appeals adopted comparable doctrine in *Morris v. New York State Department of Taxation and Finance*, 82 N.Y.2d 135 (1993), requiring a showing of complete domination of the corporation by its shareholders coupled with a use of that domination to commit a wrong against the plaintiff.

Management of a corporation is, by statutory default, vested in a board of directors elected by the shareholders. Section 141(a) of the DGCL provides that "the business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors." BCL § 701 is to the same effect.

The board owes fiduciary duties of care and loyalty to the corporation and its shareholders — duties that are, under Delaware law, modifiable in part by charter provisions exculpating directors for breaches of the duty of care under DGCL § 102(b)(7), but that cannot be fully waived.

The fiduciary architecture of corporate law is densely developed; canonical decisions such as *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (duty of care in the context of a sale-of-control transaction), *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (the demand-futility test for derivative actions), and the *Caremark* line beginning with *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (oversight liability), supply the framework within which corporate boards operate.

The corporation's capital structure is highly developed and standardized. Authorized capital, par value, classes and series of stock, voting and conversion rights, preemptive rights, and cumulative-voting provisions are all addressed by statute and by a deep body of common-law and contractual practice. The corporation can issue debt, preferred stock, common stock, warrants, options, and convertible securities in essentially limitless variety.

This fungibility and standardization make the corporation the form of choice for entities that intend to access public capital markets — but, as Part III.A will develop, those same attributes carry the federal tax cost of the **double tax** under Subchapter C.

The corporation is also the form whose securities-law treatment is most thoroughly worked out. Common stock and preferred stock are securities under § 2(a)(1) of the Securities Act of 1933 by express statutory enumeration, without resort to the more complex **investment contract** analysis of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946) (discussed in Part IX.A below). Reporting obligations under §§ 12, 13, and 15(d) of the Securities Exchange Act of 1934 are calibrated for corporate issuers. The body of disclosure regulation under Regulations S-K and S-X presupposes a corporate

income statement and a corporate balance sheet. For a vehicle that intends to issue equity to the public, the corporate form is not merely preferred but practically obligatory — a point relevant to Part V below.

## **B. The General Partnership**

The general partnership is, in legal-historical terms, the oldest commercial entity form recognized by the common law, predating the corporation by centuries. Under the Uniform Partnership Act of 1914 ("UPA-1914"), as in force in New York through Section 10 of the New York Partnership Law, a partnership is "an association of two or more persons to carry on as co-owners a business for profit." The Revised Uniform Partnership Act of 1997 ("RUPA"), adopted in Delaware (Del.

Code tit. 6, §§ 15-101 et seq.) and many other States, retains the same definitional core but reorients the partnership from the older "aggregate" theory toward an "entity" theory — recognizing the partnership as a juridical person distinct from its partners for most (though not all) purposes.

A general partnership requires no State filing. It arises by operation of law whenever two or more persons commence carrying on as co-owners a business for profit, and arises by inadvertence with some regularity — a circumstance addressed in cases such as *Martin v. Peyton*, 246 N.Y. 213 (1927), in which the New York Court of Appeals examined whether a complex lending arrangement amounted to a partnership notwithstanding the parties' disclaimer of partnership intent. The fact that a partnership may arise without filing is, paradoxically, both the form's greatest convenience and its greatest danger: convenience because no organizational formality is required; danger because the consequences of partnership status attach by operation of law and may surprise the parties.

Liability in a general partnership is the unmodified common-law rule: each partner is personally liable for all of the obligations of the firm. RUPA § 306 imposes joint and several liability for all partnership obligations; Section 26 of the New York Partnership Law preserves the older distinction between joint-and-several liability for partnership torts and breaches of trust on the one hand and joint liability for other obligations on the other. Liability extends to the partner's personal assets and is undischarged by the partnership's insolvency.

By operation of Section 20 of the New York Partnership Law (RUPA § 301), each partner is constituted a general agent of the firm for the apparent purpose of carrying on its business in the usual way — with the consequence that any partner may bind the partnership to obligations within the ordinary scope of its business. The combination of universal personal liability and universal agency is the principal reason the general partnership has been almost entirely displaced in modern practice by limited-liability forms.

Internal governance of the general partnership is, by default, egalitarian. Each partner has one vote irrespective of capital contribution; ordinary matters are decided by majority and extraordinary

matters by unanimity (RUPA § 401; N.Y. Partnership Law § 40). The partnership agreement may, and generally should, displace these defaults.

Fiduciary duty among partners is a doctrinal commonplace. Cardozo's formulation in *Meinhard v. Salmon*, 249 N.Y. 458 (1928) — that joint adventurers owe one another "the duty of the finest loyalty... not honesty alone, but the punctilio of an honor the most sensitive" — remains the canonical statement of partner-to-partner fiduciary obligation, although RUPA § 105(c) and modern partnership statutes permit substantial contractual modification of those duties.

Continuity of existence in the general partnership is, by historical default, fragile. Under UPA-1914 the death, withdrawal, expulsion, or bankruptcy of any partner caused dissolution and triggered winding up. RUPA softened the rule through the doctrine of "dissociation": a partner's dissociation does not necessarily dissolve the firm if the remaining partners elect to continue the business, in which case the dissociating partner's interest is purchased at fair value (RUPA §§ 601, 603, 701).

In a modern partnership operating under a comprehensive partnership agreement, the historical fragility is largely overcome by contract.

### **C. The Limited Partnership**

The limited partnership is a creature of statute. Unlike the general partnership, it cannot exist absent a State filing — a Certificate of Limited Partnership filed with the Secretary of State (DRULPA § 17-201; N.Y. Partnership Law § 121-201). The historical statutory sources are the Uniform Limited Partnership Act of 1916 ("ULPA-1916"), the Revised Uniform Limited Partnership Act of 1976 ("RULPA-1976") and its 1985 amendments, and the Uniform Limited Partnership Act of 2001 ("ULPA-2001").

New York remains on the RULPA-1976/1985 framework; Delaware operates under DRULPA, which is a lightly modified version of RULPA-1985 with substantial amendments enacted to accommodate the fund-formation industry.

The defining structural feature of the limited partnership is the bifurcation of the partner class into two categories with sharply different rights and obligations. The general partner (or general partners; there must be at least one) bears unlimited personal liability for the obligations of the firm and holds the entirety of the management authority.

The limited partners are, in the historical formulation, passive investors: their liability is capped at their capital contribution (and unreturned distributions) provided that they do not "participate in the control of the business" — the so-called "control rule" of RULPA § 303 and N.Y. Partnership Law § 121-303.

The control rule has been substantially eroded by statute over the past four decades. RULPA § 303(b) enumerates a long list of **safe harbor** activities — voting on enumerated matters, consulting with the general partner, serving as an officer of a corporate general partner, being a creditor of the partnership, attending partner meetings — that do not constitute participation in control.

ULPA-2001 went further still, abolishing the control rule altogether: under ULPA-2001, a limited partner has no liability for partnership obligations regardless of whether the limited partner participates in management. New York has not adopted ULPA-2001; the safe-harbor approach of RULPA-1976/1985 remains in force at N.Y. Partnership Law § 121-303.

As a practical matter, modern fund LPAs contractually preclude limited-partner participation in management as a matter of design rather than of liability avoidance, and the historical control rule has receded to a doctrinal background concern rather than an active planning constraint. The general partner of an LP retains unlimited personal liability — a fact that, on its face, would seem to render the LP form unattractive for the operating sponsor of an investment fund.

The classical objection is, however, neutralized by the simple expedient of inserting a single-purpose limited liability company (or, less commonly, a corporation) between the human sponsor and the fund. The general partner of a private fund is, in practice, almost invariably an LLC, with the natural-person managers holding their interests through the LLC.

Delaware's DRULPA is, among the State LP statutes, distinctively accommodating to fund practice. Section 17-1101(d) of DRULPA expressly authorizes the partnership agreement to "expand or restrict or eliminate" the duties (including fiduciary duties) of the general partner and other persons, subject only to the implied contractual covenant of good faith and fair dealing. The Delaware Supreme Court has consistently enforced these contractual modifications when negotiated by sophisticated parties; representative decisions include *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160 (Del. 2002); *Brinckerhoff v. Enbridge Energy Co.*, 159 A.3d 242 (Del. 2017); *Dieckman v. Regency GP LP*, 155 A.3d 358 (Del. 2017); and the older but still-cited *In re USACafes, L.P. Litigation*, 600 A.2d 43 (Del. Ch. 1991), which established the principle that controllers of a corporate general partner owe fiduciary duties to the limited partners notwithstanding the absence of direct privity. The depth and predictability of this jurisprudence are, by themselves, a meaningful reason that Delaware is the jurisdiction of choice for U.S. fund LPs.

New York imposes one distinctive procedural requirement on LP formation that warrants notice: the publication requirement under N.Y. Partnership Law § 121-201(c), obligating the LP to publish a notice of formation in two newspapers designated by the county clerk for six successive weeks and thereafter to file an affidavit of publication. In the New York City counties (and particularly in New York County), this requirement frequently entails out-of-pocket costs in the range of \$1,500 to \$2,500 and is a familiar administrative friction in New York-formed LPs.

It is one of several reasons that Delaware is preferred over New York as a State of formation even when the fund's principal place of business is in New York.

#### **D. The Limited Liability Company**

The limited liability company is the most recent of the four forms and represents the most significant innovation in U.S. business-entity law in the past century. The first State LLC statute was enacted in Wyoming in 1977; widespread adoption followed the Internal Revenue Service's Wyoming ruling in 1988 and accelerated dramatically after the issuance of the check-the-box regulations in 1996. By the late 1990s every State had enacted an LLC statute, and the LLC has since become the dominant form for closely-held businesses and special-purpose vehicles in the United States.

The Delaware LLC Act ("DLLCA"), at Del. Code tit. 6, §§ 18-101 et seq., and the New York Limited Liability Company Law ("LLCL"), at N.Y. LLCL §§ 101 et seq., are the principal reference statutes.

The LLC's defining innovation is the combination of two attributes that no prior form combined: a universal liability shield for all owners (members) regardless of their participation in management, and the option of pass-through tax treatment under Subchapter K of the Code.

Prior to the LLC, the choice of entity required a trade-off between the liability shield (available in the corporation but at the cost of double taxation under Subchapter C, or at the cost of substantial limitations under Subchapter S) and pass-through taxation (available in the partnership but at the cost of unlimited liability for general partners or limited management rights for limited partners). The LLC dissolved that trade-off by offering both the universal shield of the corporation and the pass-through of the partnership.

Under DLLCA § 18-303 and N.Y. LLCL § 609, the members of an LLC are not personally liable for any debt, obligation, or liability of the LLC, regardless of whether the LLC is member-managed or manager-managed and regardless of whether the member participates in management. The shield is qualified only by (i) the member's liability for the member's own torts; (ii) personal guaranties voluntarily undertaken; and (iii) traditional veil-piercing doctrines, which are imported into LLC law by analogy to corporate veil-piercing doctrine. The Delaware Court of Chancery applied veil-piercing to an LLC in *NetJets Aviation, Inc. v. LHC Communications, LLC*, 537 F.3d 168 (2d Cir. 2008) (applying Delaware law) and the analytical framework follows traditional corporate principles closely.

Internal governance of the LLC is a matter of contract, structured by the operating agreement (or, in Delaware, the limited liability company agreement). The operating agreement may provide for member management (each member has equal management authority, analogous to a general partnership), manager management (a designated manager or managers exercise authority, analogous to a corporate board or to the GP/LP split in a limited partnership), or any hybrid the drafter cares to design.

Section 18-1101(c) of DLLCA, like its LP counterpart at § 17-1101(d), permits the operating agreement to "expand or restrict or eliminate" fiduciary duties subject to the implied contractual covenant of good faith and fair dealing.

The Delaware Court of Chancery in *Auriga Capital Corp. v. Gatz Properties*, 40 A.3d 839 (Del. Ch. 2012), *aff'd sub nom. Gatz Properties, LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012), and in *Feeley v. NHAOCG, LLC*, 62 A.3d 649 (Del. Ch. 2012), addressed the default fiduciary duties of LLC managers, and the General Assembly's response (the 2013 amendments to DLLCA confirming default fiduciary duties unless modified) settled the question. New York case law on LLC fiduciary duties is more cautious but follows the same general direction; the Court of Appeals in *Pappas v. Tzolis*, 20 N.Y.3d 228 (2012), recognized that fiduciary duties between LLC members may be waived by sophisticated parties under appropriate circumstances.

New York imposes two procedural peculiarities on LLC formation that warrant notice. First, like the LP, the New York LLC is subject to the publication requirement under N.Y. LLCL § 206 — the same six-week newspaper publication and affidavit of publication regime described above. Second, N.Y. LLCL § 417 requires that a written operating agreement be adopted within ninety days of formation, although the enforceability of this requirement against **single-member LLCs** has been the subject of extensive case law and practical confusion.

Neither requirement applies to Delaware LLCs, which is one of several reasons Delaware is the preferred State of formation for most fund-related LLCs.

A distinctive feature of the LLC, as compared with the GP and LP, is its admissibility as a single-member LLC. A partnership of any form requires at least two persons (a definitional consequence of the partnership concept itself). An LLC may exist with a single member, in which case it is, by default under the check-the-box regulations, a disregarded entity for federal tax purposes — the so-called "SMLLC," which is a workhorse of investment structuring.

Single-asset SPVs are nearly always organized as SMLLCs; multi-asset holdcos are often organized as SMLLCs subordinate to a partnership-taxed LLC at the parent level; and the management company of a private fund is often an SMLLC owned by the sponsor or by a holding LLC.

## **E. Comparative Synthesis of Non-Tax Distinctions**

The principal non-tax axes of distinction among the four forms — liability exposure, formation formality, internal governance, agency authority, fiduciary modification, continuity, transferability, single-owner permissibility, and beneficial-ownership reporting — may be summarized as follows. The corporation supplies a universal liability shield, perpetual existence, a well-developed body of fiduciary-duty doctrine, and free transferability of shares; its principal disadvantages are governance rigidity and the federal tax cost discussed in Part III.

The general partnership supplies maximum management flexibility and minimal formation formality but at the cost of universal personal liability for all owners; it has, in modern practice, been almost entirely displaced. The limited partnership supplies a partial liability shield (for limited partners only) and centralized management vested in the general partner; its rigidity is, in the fund context, a feature rather than a defect, as Part IV develops.

The limited liability company supplies a universal liability shield together with maximum governance flexibility; it is the form of choice for SPVs and management entities, and is increasingly used as the operating-business form for closely-held ventures.

Two ancillary considerations are worth noting. First, the **Corporate Transparency Act**, 31 U.S.C. § 5336, and the implementing FinCEN Beneficial Ownership Information regulations at 31 C.F.R. § 1010.380, impose beneficial-ownership reporting obligations on most corporations, LPs, and LLCs formed by State filing, with twenty-three categories of exemption (most notably for SEC-registered investment companies, banks, and large operating companies). General partnerships, which are not formed by State filing, are generally outside the reporting regime.

The CTA reporting overlay is itself a meaningful factor in entity selection for closely-held vehicles and a non-trivial compliance burden for fund structures.

Second, the publication requirements imposed by New York on LPs and LLCs (but not on corporations or general partnerships) are a State-specific friction that frequently drives formation to Delaware in lieu of New York for fund-related entities.

### III. FEDERAL INCOME TAXATION: THE FOUR SUB-REGIMES

Federal income taxation of business entities is structured around four principal sub-regimes located within Chapter 1 of Subtitle A of the Code: Subchapter C (§§ 301 – 385), the regime of "ordinary" or "double-tax" corporate taxation; Subchapter S (§§ 1361 – 1379), the elective pass-through regime for closely-held domestic **corporations** meeting specified eligibility criteria; Subchapter K (§§ 701 – 777), the regime governing partnerships and LLCs taxed as partnerships; and Subchapter M (§§ 851 – 860L), the conduit regime for regulated investment companies, real estate investment trusts, and certain securitization vehicles.

The four sub-regimes do not exhaust the universe of entity-level federal taxation, but they encompass essentially all business-entity arrangements relevant to investment-vehicle design.

The check-the-box entity-classification regulations promulgated under § 7701 are the gateway to these sub-regimes. Under those regulations, an unincorporated entity organized under State law (a partnership, LLC, business trust, or association) is by default classified as a partnership if it has two or more members, or as a disregarded entity if it has a single member.

The entity may elect classification as an association taxable as a corporation by filing Form 8832, in which case it falls under Subchapter C (and may, if eligible, make a further S election under Subchapter S). State-law corporations, by contrast, are "per se" corporations under Treas. Reg. § 301.7701-2(b)(1) and cannot elect partnership classification. The check-the-box regime reduced the prior factor-based classification analysis to a clean elective system, and dramatically simplified entity-classification planning.

#### A. Subchapter C – The Corporate Regime

Subchapter C is the default regime for any State-law corporation and for any unincorporated entity that elects corporate classification under check-the-box. Its central architectural feature is the double tax: the corporation itself is taxed at the entity level on its taxable income at the rate prescribed by § 11 (currently 21% as set by the **Tax Cuts and Jobs Act of 2017**, after decades of variable graduated rates), and the shareholders are taxed again, separately, upon receipt of distributions of the corporation's after-tax earnings.

Distributions are characterized as dividends to the extent of the corporation's "earnings and profits" under §§ 301 and 316, with amounts in excess of E&P treated as a return of capital reducing basis under § 301(c)(2) and amounts in excess of basis treated as gain under § 301(c)(3).

For shareholders who are individuals, dividends paid by domestic C corporations on stock held for the requisite period are **qualified dividend income** under § 1(h)(11), taxed at long-term capital gain

rates (currently a maximum of 20%, plus the 3.8% **net investment income tax** under § 1411 where applicable).

The combined effective rate on a dollar of corporate income distributed as a qualified dividend to a high-income individual shareholder is therefore approximately 21% (corporate tax) plus 23.8% on the after-tax remainder (dividend tax including NIIT) — an effective combined rate in the range of 39.8%. Comparable income earned through a partnership and allocated to a partner taxed at the top individual rate (37%) plus NIIT or **self-employment tax** would face an effective rate of approximately 37% – 40.8%.

The taxable income of a C corporation is computed under §§ 61 and 63 with substantial modifications.

Corporate-specific provisions include the dividends-received deduction under § 243 (designed to mitigate triple taxation when one corporation receives dividends from another); the net operating loss rules of § 172, including the 80% taxable-income limitation on post-2017 NOLs imposed by TCJA; the § 163(j) limitation on business interest expense; and the corporate alternative minimum tax of § 55 imposed by the **Inflation Reduction Act of 2022** on corporations with average annual financial statement income exceeding \$1 billion.

Capital gains and ordinary income are taxed at the same rate at the corporate level (no preferential corporate rate for capital gain), and capital losses may be used only against capital gains, with limited carryback and carryforward.

A series of special provisions modify the basic regime in particular settings. Sections 301 – 318 govern distributions and stock redemptions; §§ 331 – 346 govern corporate liquidations; §§ 351 – 368 govern non-recognition transactions (incorporations and tax-free reorganizations); §§ 381 – 384 govern the carryover of tax attributes in such transactions and impose limitations under § 382 following ownership changes; §§ 1501 – 1564 govern consolidated returns of affiliated groups.

The interaction of these provisions makes Subchapter C, by general consensus, the most technically intricate area of the federal income tax. Its complexity is, in fact, a substantial part of the cost of the corporate form: tax planning for a C corporation routinely consumes professional resources well in excess of those required for a partnership or LLC of comparable complexity.

For investment vehicles, the principal disadvantage of the Subchapter C regime is the entity-level tax: a fund organized as a C corporation would, upon recognizing \$100 of investment income, retain only \$79 after federal tax (and less after State tax), with the residual subject to a second layer of tax upon distribution. This is the structural defect that Subchapters K, S, and M each address, by different mechanisms.

The principal advantages of the Subchapter C regime, in the investment-vehicle context, are also significant: the regime accommodates an unlimited number of shareholders without administrative

burden; it accommodates foreign investors without introducing effectively connected income issues at the investor level (because the investor receives only dividend income, taxed at flat 30% withholding under § 871(a) or § 881 absent treaty reduction); and it accommodates tax-exempt investors without producing unrelated business taxable income at the investor level (because dividends are excluded from UBTI under § 512(b)(1)).

These attributes make the C corporation the workhorse of **blocker corporation** planning, as Part VII.C develops.

## **B. Subchapter S — Closely-Held Corporate Pass-Through**

Subchapter S is an elective pass-through regime for State-law corporations meeting specified eligibility criteria. Section 1361 limits the eligible class to "small business corporations" — domestic corporations with no more than 100 shareholders, only one class of stock (other than differences in voting rights), and shareholders limited to U.S. individuals, certain trusts and estates, and qualified retirement plans.

A corporation eligible to elect S status may do so by filing Form 2553; the election is generally effective for the taxable year of filing if filed within the first 2½ months of the year. Once made, the election remains in effect until revoked or until the corporation ceases to qualify.

Under §§ 1366 and 1367, an S corporation's items of income, gain, loss, deduction, and credit pass through to its shareholders pro rata based on share ownership, with the shareholder's basis in S stock adjusted upward for income items and downward for distributions and loss items. The S corporation itself is generally not subject to entity-level federal income tax (a built-in-gains tax under § 1374 applies for ten years following conversion from C to S status, and a passive investment income tax under § 1375 applies in limited circumstances).

Distributions to shareholders are tax-free to the extent of the shareholder's basis in the stock.

For the investment-vehicle context, Subchapter S is, with rare exceptions, unsuitable. The 100-shareholder limit forecloses use as a fund vehicle of any institutional scale. The single-class-of-stock requirement forecloses the differentiated economic interests (e.g., the manager's **carried interest** at 20% of profits versus the limited partners' pro rata interest in capital) that fund structures uniformly require.

The shareholder-eligibility limitation forecloses participation by partnerships, LLCs, foreign persons, and most non-individual investors (including, critically, most institutional investors).

The passive investment income provisions of §§ 1362(d)(3) and 1375 — which terminate S status if passive investment income exceeds 25% of gross receipts for three consecutive years where the

corporation has accumulated earnings and profits — are an active threat to a corporation whose business consists principally of holding investment assets.

The S corporation's principal use in investment-related structures is as an alternative to a partnership-taxed LLC for the management company of a private fund or a similar service-providing entity, where the principal owner is concerned about self-employment tax exposure. In an S corporation, the owner-employee's reasonable compensation is subject to FICA, but the residual distributive share is not subject to either FICA or **SECA** — a planning result that has long been recognized but that is also a perennial target of IRS scrutiny under the "reasonable compensation" doctrine. Cases such as *David E. Watson, P.C. v. United States*, 668 F.3d 1008 (8th Cir. 2012), illustrate the IRS's willingness to recharacterize artificially low salaries as constructive compensation. Outside this narrow management-company use, Subchapter S has limited application to investment-vehicle design.

### **C. Subchapter K — The Partnership Regime**

Subchapter K is the federal tax regime for partnerships, including LLCs taxed as partnerships and other unincorporated entities classified as partnerships under check-the-box. It is the most flexible and, in many respects, the most intellectually demanding of the four sub-regimes.

Its central architectural feature is the doctrine of the partnership as a non-entity for income tax purposes: § 701 provides that "a partnership as such shall not be subject to the income tax imposed by this chapter," and § 702(a) requires the partners to take into account separately their distributive shares of the partnership's items of income, gain, loss, deduction, and credit. The partnership files an information return on Form 1065 and issues Schedule K-1 to each partner, but the partnership itself is not a taxpayer.

#### **1. Allocation of Items: § 704(b) and Substantial Economic Effect**

Subchapter K's most distinctive feature is the latitude it affords partners in allocating items of income, gain, loss, deduction, and credit. Under § 704(a), the allocation generally follows the partnership agreement; under § 704(b), an allocation that lacks **substantial economic effect** within the meaning of Treas. Reg. § 1.704-1(b)(2) is reallocated by the IRS in accordance with the partners' interests in the partnership. The substantial-economic-effect regulations supply detailed safe harbors.

The "primary test" requires (i) maintenance of capital accounts in accordance with the regulations, (ii) liquidation in accordance with positive capital account balances, and (iii) an unconditional obligation to restore deficit capital account balances on liquidation (or, in the alternative, the "qualified income offset" of the alternative test, which substitutes a remedial allocation mechanism for the deficit-restoration obligation).

The substantial-economic-effect framework permits allocation of partnership items in proportions that depart from capital ownership, provided the allocations track real economic outcomes — most importantly, that the partner who is allocated an item of loss bears the corresponding economic risk and the partner who is allocated an item of income receives the corresponding economic benefit.

The regime is the foundation of the modern fund waterfall structure: the limited partners receive 100% of returns up to a preferred return (typically an 8% IRR **hurdle rate**), then the general partner receives a "catch-up" until it has earned 20% of cumulative profits, and thereafter cumulative profits are split 80/20 between limited partners and general partner.

Each tranche of the waterfall is supported by allocations of book and tax items engineered to satisfy § 704(b) and the "target capital account" methodology that has, since the 1990s, become the dominant drafting convention.

### ***2. Contributed Property: § 704(c)***

Section 704(c) supplies special rules for property contributed to a partnership with a built-in gain or loss (i.e., where the property's fair market value at contribution differs from the contributing partner's adjusted basis). The basic principle is that the built-in gain or loss must be allocated to the contributing partner upon the partnership's subsequent disposition of the property — preventing the contributing partner from shifting the pre-contribution gain to other partners. The mechanics are governed by Treas.

Reg. § 1.704-3, which permits three methods (the traditional method, the traditional method with curative allocations, and the remedial method).

The "ceiling rule" — the limitation that book and tax allocations may not be made in excess of the partnership's actual book or tax gain on disposition — produces "book-tax disparities" of considerable practical complexity in real-estate and operating-business partnerships.

### ***3. Outside Basis and § 752 Liability Allocation***

A partner's "outside basis" in a partnership interest is determined under § 705. It is increased by contributions to the partnership, the partner's distributive share of partnership income (whether or not distributed), and the partner's share of partnership liabilities under § 752; it is decreased by distributions, the partner's distributive share of loss, and decreases in the partner's share of liabilities.

Outside basis is significant for several purposes: under § 704(d), the partner's allocable share of partnership losses is deductible only to the extent of basis (with disallowed amounts carried forward); under § 731, distributions are tax-free to the extent of basis and produce gain only to the extent they exceed basis; under § 741, the partner's gain or loss on sale of the partnership interest is computed by reference to outside basis.

The § 752 liability-sharing rules distinguish "recourse" liabilities (those for which a partner bears the economic risk of loss within the meaning of Treas. Reg. § 1.752-2) from "nonrecourse" liabilities (those for which no partner bears that risk). Recourse liabilities are allocated to the partner who bears the economic risk; nonrecourse liabilities are allocated under the three-tier waterfall of Treas. Reg. § 1.752-3.

In a general partnership, all partners share recourse liability and all receive basis credit for their share. In a limited partnership, only the general partner ordinarily bears recourse-liability risk; limited partners share only in nonrecourse liabilities. In an LLC taxed as a partnership, no member ordinarily bears personal liability for LLC debts (in the absence of a guaranty), with the consequence that LLC liabilities are generally treated as nonrecourse for § 752 purposes.

This distinction matters in practice: in leveraged real estate ventures and other strategies that depend upon basis to support loss deductions, the LLC form may produce earlier loss-suspension under § 704(d) than would a comparable LP.

#### **4. Self-Employment Tax: § 1402(a)(13) and the Limited-Partner Exception**

Self-employment tax under the Self-Employment Contributions Act ("SECA"), Code §§ 1401 – 1403, imposes a combined tax of 15.3% (12.4% Social Security up to the annual wage base, 2.9% Medicare without limit, and an additional 0.9% Medicare surtax under § 3101(b)(2) above applicable thresholds) on "net earnings from self-employment." The application of SECA to partners is one of the most consequential operational distinctions among partnership forms.

In a general partnership, the entire distributive share of each general partner is treated as net earnings from self-employment under § 1402(a) and is therefore subject to SECA in full, without regard to whether the partner actually performs services. In a limited partnership, by virtue of the express "limited partner" exception in § 1402(a)(13), the distributive share allocable to a limited partner is excluded from net earnings from self-employment, except for guaranteed payments for services rendered. The general partner's distributive share remains fully subject to SECA.

Recent litigation has, however, materially narrowed the limited-partner exception. The Tax Court in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011) rejected the argument that LLP partners performing legal services qualified as "limited partners" within the meaning of § 1402(a)(13), and the Tax Court in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. No. 12 (2023), applied a "functional analysis" to determine whether a putative "limited partner" in a State-law LP genuinely performed the role of a passive investor — holding that an LP partner who is materially active in the partnership's business is not a "limited partner, as such" within the meaning of § 1402(a)(13).

The Tax Court's functional-analysis approach was, however, decisively rejected on appeal in *Sirius Solutions, L.L.P. v. Commissioner*, No. 24-60240 (5th Cir. Jan. 16, 2026), in which the Fifth Circuit vacated and remanded the Tax Court's decision below (which had followed *Soroban*). The Fifth

Circuit held that the “single, best meaning” of “limited partner” in § 1402(a)(13) is a partner in a limited partnership who has limited liability — full stop. Applying the *Loper Bright* framework for statutory interpretation (independent judicial judgment, informed but not controlled by agency views), the court relied on contemporaneous dictionary definitions of “limited partner” from the 1971 and 1981 editions of Webster's Third New International Dictionary, the 1977 edition of The Law Dictionary, and the 1979 edition of Black's Law Dictionary, all of which defined the term by reference to limited liability rather than passivity; on the IRS's own contemporaneous instructions to Form 1065, which since 1978 had defined “limited partner” by reference to limited financial liability for partnership debts; and on the Social Security Administration's 1980 regulation under 20 C.F.R. § 404.1080(b)(3), which defined “limited partner” for the parallel Social Security self-employment-income provision by reference to limited liability. The court found the IRS's and Tax Court's “passive investor” gloss untethered to text, history, or contemporaneous agency practice, and unworkable in administration (requiring taxpayers to “balance an infinite number of factors” in a functional-analysis test).

The current state of the law is therefore in flux, and the practitioner must distinguish between forums. Within the Fifth Circuit (Texas, Louisiana, Mississippi), *Sirius Solutions* is binding on the Tax Court on remand and on appeal, and a state-law limited partner with limited liability qualifies for the § 1402(a)(13) exception on his or her distributive share regardless of services rendered to the partnership — though guaranteed payments under § 707(c) for services remain subject to SECA by the express terms of § 1402(a)(13) itself. Outside the Fifth Circuit, the Tax Court's *Soroban* functional-analysis test continues to govern Tax Court proceedings, and the question is open in the other Circuits. The IRS did not seek Supreme Court review of *Sirius Solutions*, but a circuit split is likely to develop as similar cases work their way through other Courts of Appeals, and Supreme Court review at that point is foreseeable.

For planning purposes, the conservative posture for actively-engaged LP partners outside the Fifth Circuit remains to assume SECA exposure on the distributive share under *Soroban*, while preserving the position that limited liability alone suffices under *Sirius Solutions* on subsequent appeal. Within the Fifth Circuit, by contrast, the conservative posture is the more favorable one: rely on *Sirius Solutions* for any partnership formed under Texas, Louisiana, or Mississippi law in which the relevant LP partners are state-law limited partners with limited liability, subject to the guaranteed-payments carve-out for compensation for services.

Practitioners must therefore exercise care in classifying persons as limited partners for SECA purposes when those persons are also actively engaged in the firm's business. Following the Fifth Circuit's January 2026 decision in *Sirius Solutions*, the answer depends critically on the controlling appellate forum (see preceding paragraphs); for partnerships and partners that are not within the Fifth Circuit's appellate jurisdiction, the safe assumption remains that an actively-engaged LP

partner's distributive share is subject to SECA notwithstanding the State-law label, pending further appellate development.

The treatment of LLC members under SECA is even more contested. Proposed Treasury Regulation § 1.1402(a)-2 (issued in 1997 and never finalized) would have permitted an LLC member to be treated as a limited partner for SECA purposes if the member did not personally perform more than 500 hours of service for the LLC, did not have personal liability for LLC debts, and did not have authority to contract on behalf of the LLC.

The proposed regulation has not been finalized, and the Internal Revenue Service has, in audit practice and in recent litigation, taken the position that a member who actively participates in the LLC's business cannot avoid SECA on his or her distributive share. The result is that LLC members face greater SECA uncertainty than partners in a State-law LP.

### **5. Net Investment Income Tax (§ 1411)**

The Net Investment Income Tax under § 1411 imposes a 3.8% tax on "net investment income" of individuals, estates, and trusts where modified adjusted gross income exceeds \$200,000 (single) or \$250,000 (joint). The key issue for partners and members is whether their distributive share of partnership or LLC income constitutes "net investment income."

Income subject to SECA is excluded from NIIT (avoiding double imposition of the Medicare-equivalent component), and income from a trade or business in which the taxpayer materially participates within the meaning of § 469 is generally not investment income. Conversely, income from a trade or business that is treated as passive under § 469 may be subject to NIIT.

The interaction between the SECA "limited partner" analysis under § 1402(a)(13) and the NIIT material-participation analysis under § 469 is intricate, and a partner's status under the two regimes need not, and frequently does not, coincide. The post-Soroban environment has accentuated the complexity: the same fund manager may face SECA exposure on actively-managed fund income while also facing NIIT exposure on the same income to the extent it is characterized as investment income at the underlying level.

### **6. Compensation, Guaranteed Payments, and Rev. Rul. 69-184**

Under Revenue Ruling 69-184, 1969-1 C.B. 256, a partner in a partnership may not be treated as an employee of that partnership for federal employment-tax purposes; payments to a partner for services are characterized either as "guaranteed payments" under § 707(c) (taxable as ordinary income with respect to the recipient and deductible by the partnership) or as a distributive share, but not as wages subject to FICA withholding. The same rule applies to LLC members of an LLC taxed as a partnership.

The rule has been the subject of recurrent criticism but remains in force notwithstanding several attempts at administrative reconsideration.

The practical consequences of Rev. Rul. 69-184 are several. Owner-managers of partnerships and LLCs taxed as partnerships cannot receive a W-2 from the entity. They cannot participate in cafeteria plans on a tax-favored basis (because § 125 requires "employee" status). They are, however, eligible for the self-employed health insurance deduction under § 162(l) and may make employer-side contributions to qualified retirement plans through the partnership under § 401(c).

For LLCs and partnerships that wish to put service providers on payroll, the conventional structure interposes a corporate management entity (frequently an S corporation) between the owner-managers and the operating partnership.

### **7. Carried Interest, Profits Interests, and § 1061**

The carried interest — the general partner's entitlement to a share (typically 20%) of the fund's long-term capital gains in excess of a hurdle rate — is structured as a **profits interest** in the fund partnership.

Under Revenue Procedures 93-27, 1993-2 C.B. 343, and 2001-43, 2001-2 C.B. 191, the receipt of a profits interest in exchange for services is generally not a taxable event, provided certain conditions are satisfied: (i) the profits interest does not relate to a substantially certain and predictable stream of income from partnership assets; (ii) the partner does not dispose of the profits interest within two years of receipt; and (iii) the profits interest is not a limited-partnership interest in a publicly traded partnership within the meaning of § 7704(b).

The non-taxability of profits-interest receipts is the foundation of the carried-interest structure: the general partner of the fund receives its 20% economic interest in fund profits without recognizing taxable compensation income upon receipt.

The Tax Cuts and Jobs Act of 2017 enacted Code § 1061, which extends the holding period required for long-term capital gain treatment of certain partnership interests held by service providers ("applicable partnership interests" or "APIs") from one year to three years.

Section 1061 applies to gains allocated through, or derived from the sale of, an API held in connection with the performance of substantial services in an "applicable trade or business" — defined to include the businesses of raising or returning capital and either investing in specified assets or developing specified assets. The provision applies regardless of whether the underlying entity is an LP or an LLC; what matters is the existence of a profits interest held in connection with the performance of services in an applicable trade or business.

Final regulations under § 1061 were issued in 2021 (T.D. 9945), elaborating the operative rules in considerable detail. The **One Big Beautiful Bill Act** of 2025 ("OBBBA," H.R. 1, P.L. 119-21) did not alter the taxation of carried interest, leaving § 1061 intact. The IRS continues to scrutinize fee-waiver arrangements and complex partnership structures designed to circumvent § 1061. The carried-interest planning consequences of § 1061 are addressed in Part VII.D below.

## **8. Centralized Partnership Audit Regime (BBA)**

The **Bipartisan Budget Act of 2015** ("BBA") repealed the prior partnership audit regime under TEFRA and replaced it, effective for taxable years beginning after December 31, 2017, with the **centralized partnership audit regime** now codified at §§ 6221 – 6241. Under BBA, audit adjustments are determined and assessed at the partnership level, and an "imputed underpayment" is imposed at the partnership level rather than being passed through to partners.

Eligible partnerships may elect out of BBA under § 6221(b) (small partnerships with eligible partners only), or may "push out" adjustments to the partners as they were in the year under audit through the § 6226 election.

The choice of election is a non-trivial planning matter for fund LPAs, and modern fund agreements address BBA representation, push-out elections, and indemnification provisions in some detail. The "partnership representative" — the BBA equivalent of the prior tax matters partner — has substantial authority to bind the partnership and its partners, and is a designation of consequence.

## **D. Subchapter M — Regulated Investment Companies and Real Estate Investment Trusts**

Subchapter M, comprising §§ 851 – 860L, is the federal conduit regime for two categories of pooled investment vehicles — the **regulated investment company** (the "RIC") and the real estate investment trust (the "REIT") — together with the real estate mortgage investment conduit (the "REMIC") regime under §§ 860A – 860G.

Subchapter M is, in policy terms, the natural complement to Subchapter K: where Subchapter K addresses entities with a manageable number of negotiated owners, Subchapter M addresses entities with diffuse public or institutional shareholders for which the partnership form is administratively impracticable.

The regime is an explicit congressional accommodation: the entities to which it applies are formally classified as corporations or trusts (and would, absent special treatment, suffer entity-level federal income tax under Subchapter C), but Subchapter M permits them, upon satisfaction of specified asset, income, and distribution tests, to deduct dividends paid to shareholders and thereby eliminate, in substantial part, the corporate-level tax that would otherwise be imposed.

### **1. Why Pooled Investment Vehicles Need a Separate Regime**

A natural objection is that Subchapter K — the partnership regime — already provides a fully developed conduit framework, and that pooled investment vehicles could simply be organized as partnerships rather than corporations or trusts. The objection is theoretically sound but practically untenable for several reasons.

First, the administrative burden of partnership tax compliance scales linearly with the number of partners. Each partner receives an annual Schedule K-1 reporting that partner's distributive share of dozens of separately stated items (§ 702(a)), and each partner must reconcile that information with his or her individual return. For a private fund with fifty or one hundred limited partners, this is manageable; for a mutual fund with two million retail shareholders, it is impossible.

Mutual fund shareholders receive Form 1099-DIV reporting ordinary dividends, qualified dividends, and capital gain distributions — categorical, summarized, and amenable to simple individual reporting. Schedule K-1 is not a workable substitute at retail scale.

Second, the partnership form is incompatible with the regulatory architecture of the 1940 Act. The 1940 Act presumes a corporate or statutory-trust form: it speaks of "boards of directors" or "boards of trustees," "shareholders," "redemption" of "shares," and similar concepts that map awkwardly onto partnership vocabulary.

Open-end investment companies (mutual funds), in particular, must continuously offer redeemable securities under § 22 of the 1940 Act — an attribute that fits readily within the corporate or statutory-trust form but that would impose constructive-termination and basis-tracking complications under Subchapter K.

Third, the Subchapter K rules governing allocations, basis, and book-tax disparities (§§ 704(b), 704(c), 743, 754, 755) presuppose a relatively stable group of partners with negotiated economic deals. They are poorly suited to a vehicle in which shareholders enter and exit daily at net asset value. Subchapter M sidesteps these difficulties altogether by retaining the corporate form (with its uniform per-share basis) and superimposing a deduction for dividends paid.

Fourth, certain investors — tax-exempt organizations, qualified retirement plans, and individual retirement accounts in particular — are sensitive to the unrelated business taxable income rules of §§ 511 – 514. UBTI may arise from a partnership's use of leverage (the "debt-financed income" rules of § 514) and from a partnership's conduct of trade-or-business activities. A RIC, by contrast, generally does not pass UBTI through to its shareholders, because RIC dividends are not characterized as flow-through partnership items.

This makes the RIC form materially superior to the partnership form for retail-distributed funds in which retirement-account ownership is significant.

## ***2. Subchapter M Architecture: The Statutory Bargain***

Subchapter M does not extend pass-through treatment unconditionally. The regime is, in effect, a regulatory bargain: an entity that satisfies a series of structural, asset, income, and distribution requirements may, by election, deduct dividends paid to shareholders under § 852(b)(2)(D) (for RICs) or § 857(b)(2)(B) (for REITs), with the consequence that the entity-level tax is reduced to the extent of such distributions.

The conditions upon the bargain are not incidental: they ensure that the entity is in fact functioning as a conduit (i.e., distributing substantially all of its income currently), that it is in fact diversified, and that it is in fact deriving its income from passive sources of the type Congress intended to favor.

### ***3. RIC Eligibility and the Source-of-Income Test***

A RIC, as defined in Code § 851(a), is a domestic corporation that, at all times during the taxable year, is registered under the 1940 Act either as a management company (open-end or closed-end) or as a unit investment trust. Business development companies elected to be regulated under §§ 55 through 65 of the 1940 Act are also eligible. The election to be taxed as a RIC is made under § 851(b)(1) by filing with the original return for the first taxable year in which the entity desires the election to apply, and remains in effect until terminated.

It is essential to appreciate that 1940 Act registration is a predicate to RIC status: an unregistered private fund relying upon § 3(c)(1) or § 3(c)(7) of the 1940 Act — i.e., a hedge fund or private equity fund — cannot be a RIC, and is for that reason ordinarily organized as a Delaware limited partnership and taxed under Subchapter K rather than Subchapter M.

Code § 851(b)(2) requires that at least 90% of the RIC's gross income for the taxable year consist of: (i) dividends, interest, payments with respect to securities loans, gains from the sale or other disposition of stock or securities, and other income derived with respect to its business of investing; and (ii) net income derived from an interest in a "qualified publicly traded partnership" as defined in § 851(h). The test is computed annually on a gross-income basis.

Failure of the 90% test was, prior to the 2010 amendments, a complete disqualifier for the year, although Code § 851(i), enacted by the **Regulated Investment Company Modernization Act of 2010**, provides limited cure procedures for de minimis or reasonable-cause failures.

### ***4. RIC Asset Diversification Test***

Code § 851(b)(3) requires that, at the close of each quarter of the taxable year: (i) at least 50% of the value of the RIC's total assets must be represented by cash, cash items, Government securities, securities of other RICs, and other securities, with such other securities limited, as to any one issuer, to an amount not greater than 5% of the value of the RIC's total assets and to not more than 10% of the outstanding voting securities of such issuer (the "50% bucket"); and (ii) not more than 25% of the value of the RIC's total assets may be invested in (A) the securities of any one issuer, (B) the securities of two or more issuers controlled by the RIC and engaged in the same or similar trades or businesses, or (C) the securities of one or more qualified publicly traded partnerships (the "25% cap").

The diversification test is the principal substantive constraint that distinguishes a RIC from an unregulated holding company. It enforces, at the level of tax law, a meaningful diversification that parallels (but is not identical to) the diversification expectations of the 1940 Act itself. Compliance is tested at the close of each calendar quarter; a corporation that fails the test at quarter-end has 30

days under § 851(d)(1) to cure by disposition of assets, and § 851(d)(2) permits a "reasonable cause" cure with payment of a tax under § 851(i).

Practitioners commonly maintain real-time compliance dashboards monitoring 5%/10% issuer concentration and the 50%/25% bucket allocations, given the catastrophic consequences of failure.

### **5. RIC Distribution Requirement and Excise Tax**

A RIC qualifies for the dividends-paid deduction under § 852(b)(2)(D) only if, in addition to satisfying the eligibility, source, and asset tests, it distributes at least 90% of the sum of (i) its "investment company taxable income" (computed without regard to the dividends-paid deduction and without regard to net capital gain) and (ii) its net tax-exempt interest income, if any.

The 90% distribution requirement is the analogue, in the RIC context, of the partnership's mandatory pass-through of all items of income on Schedule K-1: it ensures that income is taxed currently at the shareholder level rather than accumulated at the entity level.

A separate excise tax under § 4982 imposes a 4% tax on RIC undistributed income, computed on a calendar-year basis without regard to the RIC's taxable year, requiring distribution of 98% of ordinary income and 98.2% of capital gain net income. The interaction of the § 852 distribution requirement (taxable-year basis, 90% threshold), the § 852(a) qualification requirement (also taxable-year basis), and the § 4982 excise tax (calendar-year basis, 98% / 98.2% threshold) generates the practical distribution targets that govern most RIC operations.

RICs commonly distribute 100% of their investment company taxable income and substantially all of their net capital gain.

### **6. Character Pass-Through and the Single Layer of Tax**

A central feature of the RIC regime is the preservation of certain character attributes as items of income pass from the RIC to its shareholders. Long-term capital gain at the RIC level may be distributed as a **capital gain dividend** under § 852(b)(3)(C), retaining its character as long-term capital gain in the hands of the shareholder.

Tax-exempt interest at the RIC level may be paid out as an **exempt-interest dividend** under § 852(b)(5), retaining its tax-exempt character (provided the RIC qualifies under § 852(b)(5)(A) by holding at least 50% of its assets in tax-exempt obligations at the close of each quarter — the threshold for a "tax-exempt bond fund"). Qualified dividend income received by the RIC may be passed through to shareholders as qualified dividend income under § 854.

What is not passed through, however, is the character of items as ordinary deductions. A RIC may not pass through net operating losses to its shareholders: an NOL is held at the entity level and may be carried forward under § 852(b)(2)(B), but it does not generate a deduction at the shareholder level. Similarly, capital losses are netted at the RIC level and may be carried forward to offset future

capital gain (§ 1212(a)(3) for RICs, with rules modified by the Modernization Act of 2010 to permit indefinite carryforward and preserve character).

This is a significant departure from Subchapter K, where losses and deductions flow through immediately to the partner level, subject to basis, at-risk, and passive-activity limitations.

### **7. Real Estate Investment Trusts: §§ 856 – 860**

The REIT regime parallels the RIC regime in structure but differs in detail. A REIT, defined under § 856(a), is a corporation, trust, or association that is managed by trustees or directors, has transferable shares evidencing ownership, would otherwise be taxable as a domestic corporation, is not a financial institution (§ 582) or insurance company, is owned beneficially by 100 or more persons (§ 856(a)(5)), and is not "closely held" (the so-called "5/50 rule" of § 856(h), prohibiting five or fewer individuals from owning more than 50% of the value of the REIT's shares).

A REIT must satisfy two income tests rather than one: under § 856(c)(2), at least 75% of its gross income must consist of real-property rents, mortgage interest, gains from the sale of real property, dividends from other REITs, and certain other narrowly-defined real-estate-related items; and under § 856(c)(3), at least 95% of its gross income must consist of the items described in § 856(c)(2) plus other passive-type income. The asset test under § 856(c)(4) requires that at least 75% of the value of total assets consist of real estate, cash, and Government securities.

The distribution test under § 857(a) requires distribution of at least 90% of REIT taxable income.

Several features of the REIT regime warrant notice. First, "real-property rents" are statutorily defined under § 856(d) and exclude rents that depend on the income or profits of the tenant (with limited exceptions), rents from related-party tenants, and rents attributable to non-customary services rendered to tenants.

Second, the **taxable REIT subsidiary** ("TRS") regime under § 856(l) permits a REIT to own a corporate subsidiary that may earn non-qualifying income, perform non-customary services, and engage in active business, subject to a limitation that not more than 20% (formerly 25%) of the REIT's total assets may be represented by TRS securities.

Third, REIT distributions retain their character as ordinary income (not generally as qualified dividend income, though § 199A permits a 20% deduction for individual REIT shareholders), capital gain (under § 857(b)(3)(B)), or return of capital. The UPREIT and **DownREIT** structures developed in REIT practice are addressed in Part VII.G below.

## **E. Comparative Synthesis: Mechanism of Conduit Treatment**

The four sub-regimes pursue the common policy objective of avoiding (or, in the case of Subchapter C, accepting) the double tax through structurally distinct mechanisms. Subchapter C imposes the

double tax: entity-level tax under § 11, plus shareholder-level tax on distributions. Subchapter S achieves pass-through by treating the corporation's items as flowing through directly to a closely-held shareholder group, but subject to the 100-shareholder cap, single-class-of-stock requirement, and shareholder-eligibility limitations that confine its use.

Subchapter K achieves pass-through by treating the partnership as a non-entity for income tax purposes, with all items flowing through on Schedule K-1 to the partners. Subchapter M achieves pass-through by retaining the corporate or trust form but allowing a deduction for dividends paid, thereby reducing the entity-level tax to substantially zero where the entity distributes substantially all of its income.

The four sub-regimes have, in practice, sorted themselves to particular vehicle types. Subchapter C is the regime of the operating corporation, the closely-held family corporation that has not made an S election, and the blocker corporation interposed in fund structures. Subchapter S is the regime of the closely-held operating business and the management company, with limited application to investment vehicles per se.

Subchapter K is the regime of the privately negotiated, owner-managed, flexibly-allocated investment vehicle — most prominently the private fund LP and its associated GP and management LLCs. Subchapter M is the regime of the publicly distributed, professionally managed, broadly diversified pool — most prominently the mutual fund, the ETF, the closed-end fund, the BDC, the REIT, and the REMIC.

A comparison of the principal mechanical features may be summarized as follows. With respect to the mechanism of conduit treatment, Subchapter K is a true non-entity pass-through; Subchapter M is a deduction-based dividend-paid mechanism that mimics pass-through; Subchapter S is a hybrid that treats the entity as a corporation for some purposes but as a pass-through for others; Subchapter C is no pass-through at all.

With respect to loss flow-through, Subchapter K is the most generous (subject to basis, at-risk, and passive-activity limitations); Subchapter S is similar but with simpler basis mechanics; Subchapter M traps losses at the entity level and does not pass them through to shareholders; Subchapter C also traps losses at the entity level. With respect to allocation flexibility, Subchapter K is unique: special allocations satisfying § 704(b) substantial economic effect are permitted to a degree that no other regime approaches.

With respect to administrative burden, Subchapter K is the most burdensome at the investor level (Schedule K-1) and Subchapter M is the most efficient (Form 1099-DIV).

## **F. Incorporation Transfers and the Taxation of Stock Issuance: I.R.C. § 351 and Related Provisions**

The four sub-regimes treated above govern how an entity is taxed once it is operating. A logically prior question — and one that the foregoing analysis presupposes — is how the entity comes into existence on a tax-free basis in the first place. When a founder, sponsor, or investor contributes cash or property to a corporation in exchange for stock, the transaction is, in form, a sale of property (the contributed asset) for consideration (the stock). Absent a specific nonrecognition rule, the contributor would recognize gain to the extent the contributed property had appreciated. Section 351 of the Internal Revenue Code supplies that nonrecognition rule for corporations, and the parallel rule of Section 721 supplies it for partnerships and partnership-taxed LLCs. Because virtually every entity discussed in this Guide is capitalized through such a contribution, the mechanics of Section 351 are foundational to the entire structure.

### **1. The General Rule and the “Control” Requirement**

Section 351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock of that corporation, and immediately after the exchange those persons are in “control” of the corporation. Control is defined in Section 368(c) as the ownership of at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent of the total number of shares of each class of nonvoting stock. The control test is applied to the transferors as a group, not individually, and is measured immediately after the exchange. Three points recur in practice. First, services are not “property”; a person who receives stock solely in exchange for services is taxed on the value of that stock as compensation and, more importantly, is not counted among the transferor group for purposes of the 80 percent control test — a trap that can disqualify the entire transaction if a founder takes “sweat equity” in the same issuance. Second, the requirement that stock be received “solely” in exchange for property is relaxed by the boot rules described below. Third, because control is tested as a group, a contribution by a new investor to an existing corporation will often fail Section 351 unless the new investor and existing shareholders who also contribute property together satisfy the 80 percent threshold — which is why follow-on financing rounds are generally taxable events to the contributing investor only to the extent of any gain, and are usually structured as cash purchases (where the investor has no built-in gain to recognize) rather than appreciated-property contributions.

### **2. Boot, Liability Assumption, and Gain Recognition**

Where the transferor receives money or other property (“boot”) in addition to stock, Section 351(b) requires the transferor to recognize gain — but not loss — in an amount not exceeding the lesser of the realized gain or the fair market value of the boot received. Loss is never recognized in a Section 351 exchange, even where boot is received. The assumption of the transferor’s liabilities by the corporation is generally not treated as boot under Section 357(a), reflecting the policy that a transferor who is merely relieved of debt has not cashed out of the investment. Two exceptions are important. Under Section 357(b), if the principal purpose of the liability assumption is tax avoidance or is not a bona fide business purpose, the entire amount of liabilities assumed is treated as boot. Under Section 357(c), if the total liabilities assumed exceed the transferor’s aggregate adjusted

basis in the property contributed, the excess is recognized as gain — a rule that frequently surprises real-estate contributors who transfer property encumbered by nonrecourse debt in excess of basis.

### **3. Basis Consequences: Substituted and Carryover Basis**

The deferral achieved by Section 351 is exactly that — a deferral, not a permanent exclusion — and the basis rules are the mechanism that preserves the unrecognized gain for later recognition. Under Section 358, the transferor's basis in the stock received is a substituted basis: it equals the basis of the property contributed, decreased by the amount of money and the fair market value of any other boot received and by liabilities assumed by the corporation, and increased by any gain recognized on the exchange. The effect is that the gain deferred on the contribution is built into the stock and will be recognized when the stock is later sold. On the other side of the transaction, Section 362 gives the corporation a carryover basis in the contributed property equal to the transferor's basis, increased by any gain the transferor recognized; the same deferred gain is thus also preserved at the corporate level, producing the characteristic “double” preservation of built-in gain that distinguishes a carryover-basis incorporation from a taxable purchase. Finally, Section 1032 confirms that the corporation itself recognizes no gain or loss on the receipt of money or property in exchange for its own stock, so the issuance is nonrecognition at both levels.

### **4. Relationship to the Partnership Rule (§ 721) and to Reorganizations (§ 368)**

The partnership analogue, Section 721, is in some respects more permissive than Section 351: a contribution of property to a partnership or partnership-taxed LLC in exchange for a partnership interest is generally tax-free without any control requirement, which is one of the structural reasons the limited partnership and the LLC are so flexible as fund and holding vehicles (developed in Parts IV and VI). Section 721 has its own important exception for contributions to an “investment company,” which can cause gain recognition where the contribution effects a diversification of the contributors' portfolios — a rule of direct relevance to pooled investment vehicles and one that fund sponsors must monitor when accepting in-kind contributions of marketable securities. Section 351 likewise contains an investment-company exception in Section 351(e) that denies nonrecognition to transfers to a corporation that is an investment company, preventing taxpayers from using a corporate incorporation to achieve tax-free diversification. Where an existing entity is being restructured rather than newly capitalized, the incorporation may instead fall within the reorganization provisions of Section 368 (for example, a Section 368(a)(1)(F) mere change of identity or form, or a Section 351 exchange that overlaps with a Section 368 reorganization); the provisions are not mutually exclusive, and a single transaction is frequently analyzed under both.

## **G. Founder- and Investor-Stock Tax Provisions: Qualified Small Business Stock (§ 1202), § 1045 Rollovers, and § 1244 Ordinary-Loss Treatment**

Two provisions of the Code create powerful, asymmetric incentives that bear directly on the choice between a C corporation and a pass-through vehicle for an operating business expected to be sold — and therefore on the IPO-track and portfolio-company analysis in Part V. Both apply only to stock

of a C corporation; neither is available to LLC members, S-corporation shareholders, or partners. Their availability is one of the few considerations that cuts decisively in favor of the C corporation for a growth company, notwithstanding the double-tax cost of the C regime analyzed above.

### **1. Section 1202 — The Qualified Small Business Stock Gain Exclusion**

Section 1202 permits a non-corporate holder of “qualified small business stock” (QSBS) to exclude from gross income a substantial portion of the gain on a sale of that stock. To qualify, the stock must be stock of a domestic C corporation; it must be acquired by the holder at original issuance in exchange for money, other property, or services (stock bought on the secondary market does not qualify); the corporation must satisfy an active-business requirement under which at least 80 percent of its assets are used in the active conduct of a qualified trade or business (and certain service, financial, and investment businesses are categorically excluded); and the corporation must meet a gross-assets ceiling at the time of issuance. Because LLCs, S corporations, and partnerships cannot issue QSBS, a founder anticipating a sale must weigh the QSBS opportunity against the pass-through advantages those vehicles offer during the operating period.

The One Big Beautiful Bill Act, enacted July 4, 2025, significantly expanded Section 1202 for stock acquired after that date, while leaving the prior rules in place for stock acquired on or before July 4, 2025. Three changes are central. First, the aggregate gross-assets ceiling for a qualifying issuer rose from \$50 million to \$75 million (indexed for inflation after 2026), expanding the universe of companies whose stock can qualify. Second, the per-issuer cap on excludable gain rose from \$10 million to \$15 million (also indexed after 2026), retaining the alternative cap of ten times the holder’s aggregate adjusted basis. Third, and most consequentially for planning, the formerly rigid five-year holding period was replaced for post-enactment stock by a tiered schedule: a 50 percent exclusion after a three-year holding period, 75 percent after four years, and 100 percent after five years. The Act also removed the alternative-minimum-tax preference for the excluded gain across all tiers, so that the exclusion is no longer eroded by AMT leakage. For stock issued on or before July 4, 2025, the prior regime continues to govern — a \$50 million asset ceiling, a \$10 million cap, a single five-year holding period for the full 100 percent exclusion, and the older partial-exclusion percentages for stock acquired in earlier windows.

Two structural points follow. Because the new regime applies only to stock acquired after July 4, 2025, holders of pre-Act and post-Act QSBS in the same enterprise are subject to different rules, and sale planning should distinguish the two tranches to maximize the aggregate exclusion. And because each non-corporate holder has its own per-issuer cap, the exclusion can be multiplied across separate taxpayers — for example, by gifting QSBS to non-grantor trusts established for family members, each of which is a distinct taxpayer entitled to its own cap, a technique sometimes described as “stacking.”

### **2. Section 1045 — Rollover of QSBS Gain**

Section 1045 supplies a companion deferral for a holder who has not yet satisfied the applicable holding period or who prefers to redeploy proceeds rather than realize the exclusion. A holder who has held QSBS for more than six months may elect to roll over the gain on its sale by reinvesting the proceeds in replacement QSBS within sixty days, deferring recognition and tacking the prior holding period onto the replacement stock. In the post-Act environment of tiered exclusions, Section 1045 is most useful to a holder who would otherwise sell before the five-year mark and accept only a 50 or 75 percent exclusion: by rolling the proceeds into new QSBS and tacking the holding period, the holder preserves the path to a full 100 percent exclusion.

### **3. Section 1244 — Ordinary-Loss Treatment on Small-Business Stock**

Section 1244 addresses the opposite outcome — a loss rather than a gain — and is the mirror image of the QSBS incentive. Where stock of a qualifying small business corporation is sold at a loss or becomes worthless, Section 1244 allows an individual holder to treat the loss as an ordinary loss rather than a capital loss, up to \$50,000 per year (\$100,000 on a joint return), with any excess treated as a capital loss. Ordinary-loss characterization is valuable because it is not subject to the capital-loss limitation that otherwise restricts the deductibility of capital losses against ordinary income. To qualify, the issuer must be a domestic corporation whose aggregate capital did not exceed \$1 million when the stock was issued; the corporation must derive more than half of its gross receipts from active business operations rather than passive sources; and the stock must have been issued for money or property, not services. Section 1244 and Section 1202 are not mutually exclusive: a single block of C-corporation stock can be structured to qualify for both, giving the founder the upside of a Section 1202 exclusion if the venture succeeds and the cushion of a Section 1244 ordinary loss if it fails. Capturing both treatments requires attention at the time of issuance — in particular, issuance for cash or property rather than services, and contemporaneous documentation of the corporation's eligibility — which is the practical reason these elections belong on the incorporation checklist rather than the exit checklist.

## IV. WHY THE LIMITED PARTNERSHIP PREDOMINATES IN PRIVATE FUNDS

The empirical observation that the limited partnership is the dominant vehicle for institutional-quality private investment funds is so consistent across strategy types, jurisdictions, and decades that it warrants treatment as a structural fact rather than merely a preference. Private equity funds, hedge funds, venture capital funds, real estate funds, private credit funds, and private investment funds of essentially every other description are, with overwhelming consistency, organized as Delaware limited partnerships.

The reasons for this convergence are not coincidental: they are a confluence of structural, regulatory, tax, contractual, and institutional factors that together make the LP form the optimal solution to the particular problems that private fund formation presents.

Nine principal factors drive the predominance of the LP form. First, the rigid bifurcation of the partner class — the GP holds management authority, the LPs are passive investors — maps with unusual precision onto the economic relationship between the fund's sponsor and its investors.

The sponsor exercises discretionary investment authority and is appropriately treated as a fiduciary to the investors; the investors contribute capital and are appropriately denied participation in operational decisions, both because they typically lack the relevant expertise and because such participation would compromise the sponsor's ability to execute the investment program consistently.

The LP's statutory architecture of GP-LP separation supplies exactly the structural template that this economic relationship requires. By contrast, the LLC's greater governance flexibility — its ability to admit members with shared management authority, to designate managers who are not themselves members, and to layer complex voting rights — is in this context not a feature but a defect, because it invites the fund agreement to contain governance provisions that depart from the optimal sponsor-investor template.

Second, the LP's statutory architecture maps cleanly onto the regulatory frameworks under which private funds operate. The 1940 Act's § 3(c)(1) and § 3(c)(7) exclusions presuppose a sharp distinction between the fund and its sponsor — a distinction the LP form embodies through its GP-LP wall. The Advisers Act's regulatory framework presupposes an "investment adviser" entity distinct from the "client" fund — again, a distinction the LP form embodies through the separation of the management company from the fund LP.

ERISA's plan-asset analysis, the Volcker Rule's **covered fund** definition, and FATCA and CRS reporting obligations all interface with the LP form's structural separations more naturally than they would interface with the looser structures of an LLC.

Third, the LP form interacts straightforwardly with Subchapter K of the Code. Section 704(b) allocations, § 752 liability sharing, and § 743(b) basis adjustments are well-developed in the LP context and have been the subject of extensive regulatory and judicial elaboration. The carried-interest waterfall, the staple of fund economics, is constructed through § 704(b) special allocations that have been refined over decades of fund-formation practice.

The LP's § 1402(a)(13) "limited partner" exception from SECA (although recently narrowed by Soroban) supplies cleaner SECA treatment than the uncertain LLC analysis would.

Fourth, the depth of Delaware fiduciary-duty jurisprudence governing the GP-LP relationship is unmatched in any other entity form. The decades of cases interpreting DRULPA, including the modifications of fiduciary duty permitted under § 17-1101(d), supply predictable rules to which sophisticated counterparties can negotiate. The Delaware courts have, with great consistency, enforced the contractual modifications negotiated by sophisticated parties in fund LPAs, providing the substantive certainty that fund sponsors and institutional limited partners require.

Fifth, the standardization of LP fund agreement terms — driven by institutional investor consortia such as the Institutional Limited Partners Association ("ILPA"), the convergence of practice among the major law firms representing fund sponsors, and the institutional investor diligence process — has produced a body of "market" terms against which any particular fund agreement is benchmarked.

This standardization reduces transaction costs, accelerates negotiation, and benefits both sponsors (who can offer terms calibrated to institutional expectations) and investors (who can diligence the fund's deviations from market terms efficiently).

Sixth, the LP form's operational rigidity is, in the fund context, a feature rather than a defect. A fund LPA is a long-term commitment among the sponsor and the investors, with the LPs typically committed for a ten-year (or longer) fund life. The LP's statutory framework, its inflexibility about management authority, and its preset rules on withdrawal and dissolution are all sources of stability that an LLC's greater flexibility would undermine.

Seventh, the LP's statutory framework accommodates with greater ease the sponsor-side carried-interest structure than would alternative forms. The GP's entitlement to a profits interest in the fund — implemented through carefully calibrated § 704(b) allocations — is structurally facilitated by the LP's rigid GP-LP wall, with the GP's economic interest standing distinct from and senior to the LPs' interests in a way that maps naturally onto the LP form.

Eighth, the LP form's well-developed body of bankruptcy and insolvency law provides predictability in distress scenarios. Decades of bankruptcy practice involving LP fund vehicles, with developed doctrine on substantive consolidation, fraudulent-transfer analysis, and creditor priority, supply the certainty necessary for the substantial bank lending and prime-brokerage relationships on which most institutional funds depend.

Ninth, the LP form retains an institutional gravitational pull that, while not itself a "reason" for the choice in any individual case, contributes meaningfully to the form's continued dominance. Institutional limited partners (pension funds, endowments, sovereign wealth funds, family offices) are organizationally and procedurally adapted to investing in LP-form vehicles, with diligence checklists, fund documents, side letters, and reporting requirements all calibrated to the LP.

A sponsor proposing an alternative form would face friction from institutional investor counsel and operational staff, and this friction is itself a meaningful disincentive to departure from the dominant form.

The classical objection to the LP form — the unlimited personal liability of the GP — is, as noted in Part II.C above, neutralized by the simple expedient of inserting an LLC between the natural-person sponsor and the fund. The resulting three-tier structure (sponsor → GP LLC → fund LP, with the fund LP in turn holding portfolio investments through wholly-owned SMLLCs or partnership-taxed LLCs) has become the institutional default.

## V. WHERE THE CORPORATION IS THE BEST FIT

Notwithstanding the LP's predominance as the primary fund vehicle, the corporation retains a number of specific roles in which it is the optimal — and frequently the only practicable — form. Five such roles warrant treatment: the Subchapter M vehicle (RIC, REIT, or BDC); the blocker corporation interposed to manage UBTI or ECI; the IPO-track operating company that may also be a fund portfolio investment; the S corporation as a management vehicle in narrow circumstances; and the SPAC as a specialized public-market vehicle.

### A. The Subchapter M Vehicle

For retail-distributed pooled investments, the corporate or statutory-trust form combined with the Subchapter M election is the only workable architecture. The administrative impossibility of partnership-form K-1 reporting to millions of retail shareholders, the 1940 Act's presupposition of a corporate or trust form, and the regulatory framework for open-end fund redemption and daily NAV pricing together make the corporate-Subchapter M model the unique solution to the retail pooled-investment problem.

Within the Subchapter M space, the choice between corporate and statutory-trust form is largely an aesthetic and administrative preference. Massachusetts business trusts dominated the historical mutual-fund industry; **Delaware statutory trusts** have largely supplanted them in recent decades, owing to the Delaware framework's flexibility and the depth of the Delaware Court of Chancery's jurisprudence.

Maryland corporations remain common as the corporate form of choice for closed-end funds and BDCs, both because Maryland's corporation statute is itself fund-friendly and because Maryland law accommodates the specialized governance arrangements typical of these vehicles.

### B. Blocker Corporations

A blocker corporation is a wholly-owned subsidiary of a fund LP, interposed between the fund LP and a particular portfolio investment, that serves to convert what would otherwise be UBTI or ECI flow-through at the fund level into corporate-level dividend income that is properly excluded from UBTI under § 512(b)(1) and properly taxed (only at flat 30% withholding rate, or treaty-reduced rate) for non-U.S. limited partners.

The blocker absorbs the entity-level federal tax that would otherwise create the UBTI or ECI problem, and the LPs receive dividend income that escapes those characterizations.

Blockers are organized as Delaware C corporations almost without exception. They may be organized as U.S. domestic corporations or as offshore (typically Cayman Islands) corporations that have not elected partnership classification under check-the-box. The choice between domestic and offshore blocker depends on the investor base, the investment strategy, and the specific tax characteristics being blocked.

Domestic blockers are simpler administratively but face higher U.S. corporate tax; offshore blockers avoid U.S. corporate tax on non-U.S.-source income but introduce CFC, PFIC, and Subpart F complications. The detailed analysis of blocker structures is taken up in Part VII.C below.

### **C. IPO-Track Portfolio Companies**

A fund's portfolio investment in an operating business that is destined for an eventual initial public offering must, at some point before the IPO, be organized as a C corporation. This is not because partnership form is impossible for an operating business — many operating businesses are organized as LLCs or LPs — but because of three considerations relating to the IPO process itself.

First, the public equity markets trade corporate stock, and the registration statements and underwriting documents for a U.S. IPO presuppose corporate-form equity securities. Second, the equity incentive arrangements typical of pre-IPO companies (stock options, restricted stock, restricted stock units) are calibrated to corporate form and are administratively impossible in partnership form.

Third, the federal income tax-free reorganization rules of § 368 — which permit pre-IPO restructuring, post-IPO acquisitions of other companies, and similar transactions on a tax-free basis — are available only to corporations, not to partnerships.

Pre-IPO operating businesses are accordingly organized as Delaware C corporations, with the pre-IPO equity held by the fund LP either directly (as common stock or preferred stock) or through an intervening SPV.

The "Up-C" structure — in which the operating business remains a partnership and the IPO-issuer is a C corporation that holds the partnership interest — has been used in a number of transactions to capture the preferential pass-through tax treatment of the partnership form while still providing IPO-compatible equity for public investors, but it remains a specialized arrangement rather than the general practice.

#### **D. The S Corporation as Management Vehicle**

The S corporation's use in fund-related structures is generally confined to the management company role, where the principal owner is an active manager and the principal tax-planning objective is to minimize self-employment tax exposure. As described in Part III.B above, the S corporation enables the owner-manager to receive a "reasonable" W-2 salary subject to FICA, with the residual distributive share escaping both FICA and SECA.

Outside this narrow use, the S corporation has limited application to investment-vehicle structures, with the 100-shareholder cap, single-class-of-stock requirement, and shareholder-eligibility limitations foreclosing the broader applications that the LLC and the LP can satisfy.

#### **E. SPACs and Specialized Public-Market Vehicles**

A special-purpose acquisition company ("SPAC") is a publicly-traded shell corporation organized for the purpose of acquiring one or more operating businesses through a "de-SPAC" merger. The SPAC structure has, during certain periods of capital-market enthusiasm, served as a quasi-substitute for the traditional IPO process, with the operating business merging into the SPAC and thereby becoming a public company without the disclosure and underwriting machinery of a traditional IPO.

SPACs are organized as Delaware corporations, both for the IPO-compatibility reasons described above and because the specialized SPAC governance arrangements (trust account, redemption rights, business-combination deadline) interface most naturally with corporate form.

## **VI. THE LLC: OPTIMAL VEHICLE FOR SPVs, HOLDCOS, AND MANAGEMENT COMPANIES**

The limited liability company occupies the institutional middle ground between the LP (preferred for fund vehicles) and the corporation (preferred for retail-distributed pooled investments and IPO-track portfolio companies). The LLC is rarely the optimal form for either the primary fund vehicle or the public-markets operating company, but it is the universal choice for a long list of supporting and ancillary entities in the fund architecture. Five such roles warrant treatment.

### **A. The General Partner LLC**

The GP of essentially every institutional-quality private fund is organized as a single-purpose LLC. The LLC supplies the universal liability shield that the natural-person sponsor or sponsors require to insulate themselves from the LP's residual unlimited-liability exposure attaching to the GP. The LLC's governance flexibility accommodates the sponsor's economic and decisional arrangements — multiple members with carry-allocation differentials, vesting schedules, and tag-along/drag-along provisions.

The LLC's pass-through tax treatment under Subchapter K (or, for SMLLCs, disregarded-entity treatment) keeps the GP's tax profile simple: the carried interest flows through the GP LLC and the management fee flows through the management company without additional layers of tax.

### **B. The Management Company LLC**

The management company of a private fund is, like the GP, almost invariably organized as an LLC. The same considerations of liability shielding, governance flexibility, and pass-through tax treatment apply. The management company's additional regulatory characteristic — that it is the investment-adviser entity, registered with the SEC under the Advisers Act or, more commonly, claiming exemption as an ERA — does not affect the choice of entity form.

In some cases, particularly where SECA optimization for the owner-managers is a meaningful concern, the management company may be organized as an S corporation rather than as an LLC, as noted in Part V.D above.

### **C. Sponsor Parent / Holdco LLCs**

The sponsor's parent or holding company — the entity through which the principal natural-person principals hold their interests in the GP and the management company — is typically organized as an LLC.

This entity serves to consolidate the principals' interests in the firm's economics, to provide a vehicle for firm-level governance (including admission of new principals, departure of existing principals, and the firm's succession planning), and to enable internal economic arrangements among principals (vesting schedules, deferred compensation, and so on) that would be administratively cumbersome to manage at the level of each individual fund's GP and management company.

#### **D. Special-Purpose Vehicles for Portfolio Investments**

A fund's portfolio investments are, with rare exceptions, held through wholly-owned single-purpose SPVs rather than directly by the fund LP. Each SPV is, almost universally, a Delaware LLC.

The SPV's liability shield isolates the fund LP from the operating liabilities of the particular portfolio investment; the SPV's structural neutrality avoids commingling distinct portfolio assets within a single holding entity; the SMLLC's disregarded-entity status under check-the-box maintains the fund LP's direct tax view through to the underlying asset; and the LLC's administrative simplicity (no separate tax return, no separate State franchise tax in most cases, no separate audit) keeps the cost of the SPV layer minimal.

For investments in real estate or other physical assets, the SPV may itself hold additional sub-SPVs at the property level, producing chains of SMLLCs four or five entities deep without meaningful tax or administrative cost. This is the structural pattern that the LLC form, in combination with check-the-box, has uniquely enabled in U.S. investment practice.

#### **E. Co-Investment Vehicles, Carry Vehicles, and Other Ancillary LLCs**

The remaining ancillary entities in a typical fund architecture — co-investment vehicles offered to particular LPs alongside the main fund, dedicated carry vehicles holding the principals' carried interest pools, aggregator entities used to pool smaller investor commitments into a single LP interest in the main fund, and similar specialized vehicles — are nearly always organized as LLCs. Each such entity serves a discrete structural function and benefits from the LLC's combination of liability shielding, governance flexibility, and tax efficiency.

## VII. MULTI-ENTITY INVESTMENT STRUCTURES: ARCHITECTURE AND INTERPLAY

A sophisticated investment vehicle is rarely a single entity. It is, almost without exception, a structured assembly of multiple entities — each of which is chosen for its comparative advantage in solving a discrete legal, tax, regulatory, or commercial problem. The principles developed in Parts II through VI supply the elements; the architectural patterns developed in this Part show how those elements are combined in actual fund and investment structures.

The discussion proceeds through seven archetypes: the three-tier private fund (the foundational fund-formation structure); master-feeder and parallel-fund architectures (the dominant structural pattern for institutional alternatives); blocker corporations and the mitigation of UBTI and ECI; carried-interest vehicles and § 1061 planning; SPVs, co-investment vehicles, and aggregator structures; public-market vehicles, including mutual funds, ETFs, and BDCs; and the REIT-specific UPREIT and DownREIT structures.

### A. The Three-Tier Private Fund Structure

The foundational private-fund structure, used in essentially every institutional-quality private equity, hedge fund, venture capital, real estate, or private credit fund, comprises (at minimum) four entities arrayed in a layered architecture. At the top sit the natural-person principals. Immediately below them sits a sponsor or parent LLC, taxed as a partnership under Subchapter K, which holds the principals' aggregate ownership of the firm.

Below the sponsor LLC, two parallel entities branch out: a general-partner LLC and a management-company LLC, each itself taxed as a partnership under Subchapter K.

The general-partner LLC serves as general partner of the fund LP; the management-company LLC contracts with the fund LP to provide investment-management services. Both LLCs hold their interests in single-member or multi-member configurations as the principals' economic arrangements require, and both serve as conduits for the firm's economics — the carried interest flowing through the GP LLC, and the management fee flowing through the management-company LLC.

At the operational level sits the fund LP itself — a Delaware limited partnership organized under DRULPA, taxed as a partnership under Subchapter K, with the GP LLC as its sole general partner and the institutional and high-net-worth investors as its limited partners. The fund LP is the entity that actually holds the portfolio investments, that is referenced in the offering documents, and that is the contractual counterparty to subscription agreements with each investor.

Below the fund LP sit the portfolio-investment-level entities — typically SMLLCs, with each portfolio investment held through its own SPV for liability segregation and operational reasons.

Each layer addresses a discrete problem. The principals are at the top because the firm's economics ultimately accrue to natural persons. The sponsor LLC supplies firm-level governance, succession planning, and the aggregation of principals' interests.

The GP LLC and management-company LLC are separate entities because the regulatory treatment of the GP function (the holder of management authority over the fund, and a fiduciary to the limited partners) differs from the regulatory treatment of the management-company function (the SEC-registered or exempt reporting investment adviser, and the contracting party for the investment-management agreement). The fund LP is an LP for the reasons developed in Part IV. The portfolio SPVs are LLCs for the reasons developed in Part VI.D.

Each form is the optimal choice for its specific role.

## **B. Master-Feeder and Parallel-Fund Architecture**

Most institutional-quality funds that admit non-U.S. investors or U.S. tax-exempt investors employ either a master-feeder structure or a parallel-fund structure to accommodate the different tax characterizations and regulatory needs of those investor groups. The two structures pursue the same essential objective — investor segregation by tax characterization — but achieve it through different architectural means.

In a master-feeder structure, two or more "feeder funds" sit alongside one another, each accepting a particular category of investors, and all feeders invest their capital into a single common "master fund" that holds the actual portfolio. The U.S. taxable feeder is typically a Delaware LP taxed as a partnership under Subchapter K, accepting U.S. taxable individuals and entities.

The offshore feeder is typically a Cayman Islands exempted company that has not "checked the box" — and is therefore a corporation for U.S. tax purposes — accepting U.S. tax-exempt investors and non-U.S. investors.

The master fund is typically a Cayman Islands Exempted Limited Partnership that has checked the box for partnership treatment, taxed as a partnership under Subchapter K, with the two feeders as its principal limited partners. The structure produces a single portfolio (held by the master), single investment decision-making (exercised by the GP at the master level), and single operational accounting, with the feeders serving as tax-segregation vehicles only.

The offshore feeder is a corporation for U.S. tax purposes precisely because that classification is what tax-exempt and non-U.S. investors require. For tax-exempt investors, the offshore feeder's corporate-blocker character converts what would be UBTI-bearing partnership allocations from the

master into UBTI-free corporate dividends. For non-U.S. investors, the corporate-blocker character converts what would be ECI allocations into U.S.-withholding-only dividends.

The U.S. taxable feeder is a partnership precisely because that classification is what U.S. taxable investors require, to access partnership-level losses and the favorable character of long-term capital gains and qualified dividends without an intervening layer of corporate tax.

In a parallel-fund structure, by contrast, two or more separate funds are organized to invest *pari passu* in the same investments according to a coordinated investment program, but each fund has its own portfolio, its own books, and its own investors. A typical parallel structure includes a U.S. taxable fund (Delaware LP), an offshore fund (Cayman ELP), and possibly a third fund for ERISA investors (a Delaware LP qualifying as a **Venture Capital Operating Company** or operating below the 25% benefit-plan-investor threshold).

Private equity funds, which make discrete investments held to maturity, more commonly use parallel structures; hedge funds, which require continuous unified portfolio management, more commonly use master-feeder.

### **C. Blocker Corporations and UBTI / ECI Mitigation**

Beyond the master-feeder offshore-corporation blocker described above, fund structures employ a second, more granular form of blocker — the U.S. domestic blocker corporation interposed selectively between the fund and a particular UBTI- or ECI-generating investment. The selective domestic blocker is most common in private equity and private credit funds, where a particular portfolio investment may generate UBTI for tax-exempt investors while other investments do not.

A typical structure has the fund LP making its investment in a portfolio company through a wholly-owned U.S. blocker — a Delaware C corporation — that holds the investment in the portfolio company. The fund partners receive their share of the portfolio company's economics (after corporate-level tax at the blocker) as portfolio dividends from the blocker, which are excluded from UBTI under § 512(b)(1) for tax-exempt partners and treated as portfolio dividends subject only to flat withholding for non-U.S. partners.

The cost of the structure is the corporate-level tax imposed on the blocker, partially mitigated by the blocker's use of debt and by careful management of disposition timing.

For non-U.S. investors in funds investing principally in U.S. real estate, the **FIRPTA** regime under § 897 imposes additional considerations. A non-U.S. investor's gain on disposition of a "United States real property interest" is treated as effectively connected income and is taxable accordingly, with withholding under § 1445.

The "domestically controlled qualified investment entity" exception under § 897(h)(4) provides that an interest in a domestically-controlled REIT is not a USRPI in the hands of a non-U.S. investor, and is the doctrinal foundation of much real-estate fund structuring.

#### **D. Carried-Interest Vehicles and § 1061 Planning**

The general partner's carried interest — typically 20% of the fund's long-term capital gains in excess of an 8% IRR hurdle, as developed under the standard institutional fund waterfall — is held through the GP LLC and is the principal economic asset of the fund's sponsor. The structuring of the carried-interest entity has, since the enactment of § 1061 by TCJA in 2017, become a planning subject of considerable subtlety.

The starting point is the profits-interest doctrine of Rev. Procs. 93-27 and 2001-43, which provides that the receipt of a profits interest in a partnership in exchange for services is generally non-taxable. The GP LLC, as a partner in the fund LP, holds an "applicable partnership interest" within the meaning of § 1061.

Under § 1061, gains allocated to the GP LLC through the carried interest are treated as long-term capital gains only if the underlying fund-level holding period exceeds three years; gains from assets held for one to three years are recharacterized as short-term capital gains taxable at ordinary income rates.

The three-year holding period is a non-trivial constraint, particularly for hedge funds that trade frequently and for venture capital funds that occasionally exit investments before the three-year mark. Several planning techniques have emerged. First, certain types of fund income are not subject to § 1061 (most notably, qualified dividend income, which retains its character regardless of holding period; and section 1231 gain, which under final regulations also escapes § 1061 recharacterization).

Second, the structuring of "GP commitment" capital (the GP's own invested capital in the fund, separate from the carried interest) produces non-API treatment for that portion of the GP's economic interest that represents return on its own capital rather than performance compensation.

A subsidiary structuring question is whether the principals should hold their carried-interest entitlements directly (as members of the GP LLC) or through a separate "carry vehicle" sitting between the principals and the GP LLC. The carry vehicle is, in larger and more institutionalized firms, the dominant choice, both because it permits the firm to impose vesting and forfeiture provisions on departing principals and because it simplifies the accounting and distribution mechanics for the firm's aggregate carry pool.

The carry vehicle is, again, an LLC taxed as a partnership under Subchapter K.

### **E. SPVs, Co-Investment Vehicles, and Aggregator LLCs**

A typical fund's portfolio is held not directly by the fund LP but through a chain of intermediate special-purpose vehicles. Each portfolio investment is, conventionally, held through its own SPV — typically an SMLLC owned by the fund LP, holding only the equity and debt of the single portfolio company or asset.

The SMLLC is a disregarded entity for federal tax purposes, contributing no separate tax-compliance burden, but supplies a layer of liability segregation that protects the fund from cross-claims arising from one portfolio investment's liabilities reaching another's assets.

Co-investment vehicles arise where a fund's sponsor offers certain limited partners the opportunity to invest additional capital alongside the fund in particular transactions. Co-investment is typically offered without management fees and without carried interest (or with reduced fees and carry), as a relationship-management tool with the fund's most important investors.

The co-investment vehicle is typically structured as a separate LP (with its own GP LLC) for the same Part IV reasons that drive the choice of LP at the fund level, and its limited partners are a subset of the fund's LP base.

Aggregator LLCs arise where a sponsor wishes to pool the capital commitments of multiple smaller investors into a single LP interest in the main fund. The aggregator is itself an LLC (or, in some structures, an LP), with the smaller investors as its members, and it holds an LP interest in the main fund as if it were a single institutional investor.

The structure is used principally for one-off vehicles assembled around particular transactions, for high-net-worth investor pools that would otherwise overflow the fund's investor count limits, and for "feeder" structures organized through wealth-management platforms that aggregate retail-accredited capital for institutional fund access.

### **F. Public-Market Vehicles: Mutual Funds, ETFs, and BDCs**

The corporate-form (or statutory-trust-form) RIC structure governing public-market investment vehicles is qualitatively different from the partnership-LLC structure of private funds, but it is structurally just as multi-entity.

A typical mutual fund "complex" — a sponsor offering many distinct funds under a single advisory and operational umbrella — comprises a Delaware Statutory Trust (or Maryland or Massachusetts business trust) with many "series" or "portfolios," an investment advisory entity registered as an investment adviser under the Advisers Act, a distributor (a registered broker-dealer), a transfer

agent, and a custodian (a bank or trust company holding the fund's assets in segregated accounts under § 17(f) of the 1940 Act).

The trust-form vehicle is preferred over the corporate-form vehicle in part because the Delaware Statutory Trust Act provides exceptional flexibility in the trust's governance structure, in part because the series-trust mechanism (in which a single trust may hold multiple "series" or "portfolios" with separate liability protection under § 3804) is exceptionally well-suited to fund-complex operations, and in part for historical reasons relating to State franchise taxation. The federal tax treatment is identical to that of a corporation electing RIC status under Subchapter M.

BDCs, by contrast, are typically organized as Maryland or Delaware corporations rather than as trusts, in part because the BDC's typical use as a publicly-offered (sometimes exchange-listed) closed-end vehicle benefits from the more familiar corporate governance template. The BDC's investment adviser is a separate entity (typically an LLC subsidiary of a larger asset-management firm) that registers as an investment adviser under the Advisers Act. The BDC's board of directors must include a majority of "non-interested" directors under § 56 of the 1940 Act.

## **G. REIT Structures: UPREIT and DownREIT**

The UPREIT structure (an "Umbrella Partnership REIT") is the dominant architectural form for publicly-traded equity REITs and many private REITs as well. In an UPREIT, the publicly-traded REIT (a Maryland or Delaware corporation, or a Maryland statutory trust, with shares registered under the Securities Act and listed on a national securities exchange) does not directly own real estate.

Instead, the REIT owns the general-partner interest in (and a controlling limited-partner interest in) an "operating partnership" — a Delaware LP, taxed as a partnership under Subchapter K, that actually owns the underlying real estate and conducts the REIT's operations.

The non-controlling limited-partner interests in the operating partnership (the "OP units") are held by various third parties — typically prior owners of properties contributed to the operating partnership in exchange for OP units rather than for cash or REIT shares. The principal motivation for the UPREIT structure is § 721, which provides that no gain or loss is recognized on the contribution of property to a partnership in exchange for partnership interests.

A real estate owner who wishes to monetize a property can contribute it to the operating partnership in exchange for OP units without recognizing the embedded built-in gain at the time of contribution.

The DownREIT structure is a variant in which the REIT operates a network of separate operating partnerships (rather than a single umbrella partnership) at the property or sub-portfolio level, with the REIT as the general partner or controlling limited partner of each. The DownREIT structure permits

more granular tax planning — particularly the use of property-specific operating partnerships to absorb specific properties' built-in gains under § 704(c) — at the cost of greater administrative and structural complexity.

## VIII. HEDGE-FUND TRADING-ACTIVITY TAX RULES

The federal income tax rules governing partnerships and partnership-taxed LLCs, surveyed in Part III.C above, are general-purpose rules that apply to any partnership without regard to its investment strategy. Hedge funds and other actively-trading investment vehicles, however, must navigate a layered set of additional rules that are specifically directed at active trading in securities, derivatives, and synthetic exposures.

These rules are not unique to hedge funds — they apply equally to a sole-proprietor day trader or to a registered investment company — but in practice they are most consequential for hedge funds, where high turnover, short-position trading, derivatives use, and synthetic exposure are the everyday operational mode.

This Part addresses seven such rule complexes that, taken together, define the tax topology of an actively-trading hedge fund.

Subpart VIII.A addresses the wash-sale rule of § 1091; Subpart VIII.B addresses the straddle rules of § 1092 and the related interest-and-carrying-charge disallowance of § 263(g); Subpart VIII.C addresses § 1256 contracts and the 60/40 rule; Subpart VIII.D addresses the constructive-sale rules of § 1259; Subpart VIII.E addresses the elective mark-to-market regime of § 475(f); Subpart VIII.F addresses management fee waivers and the disguised-payment-for-services rules of § 707(a)(2)(A), as recently amended by the One Big Beautiful Bill Act of 2025; and Subpart VIII.G addresses the state-and-local-tax workaround commonly known as the passthrough entity tax election, which has become a meaningful planning item for fund management companies in high-tax States.

Two preliminary observations are useful. First, these rules tend to interact: a single transaction may simultaneously implicate the wash-sale rule, the straddle rules, and the constructive-sale rules, and the operative tax outcome depends on the order in which the rules are applied and on whether any election (most consequentially the § 475(f) election) is in effect.

Second, the rules are generally directed at preventing artificial loss recognition, deferral of unrealized gain, or conversion of ordinary income into capital gain — and their architecture reflects a long-running cat-and-mouse between Congress and active trading strategies designed to exploit the realization principle. Practitioners advising hedge funds must therefore monitor not merely the literal language of the rules but also the anti-abuse policies that animate them.

## A. Wash Sales — § 1091

Section 1091 disallows a loss on the sale of a security if a "substantially identical" security is acquired, by purchase or in a fully taxable exchange, within 30 days before or after the sale. The disallowed loss is not lost permanently: it is added to the basis of the replacement security under § 1091(d), and is deferred until the replacement security is itself disposed of in a non-wash-sale transaction.

The wash-sale window thus runs 61 days in total (30 days before plus the day of sale plus 30 days after), and the rule applies symmetrically — a purchase in the 30 days before a loss sale is just as disqualifying as a purchase in the 30 days after.

The operative concept of "substantially identical" is undefined in the statute and is the subject of considerable interpretive case law and IRS guidance. Common stock of the same issuer is, of course, substantially identical to itself. Stock of one issuer is generally not substantially identical to stock of another issuer, even in the same industry. Bonds of the same issuer with substantially identical maturity, coupon, and seniority are substantially identical; bonds of the same issuer differing materially in those features are generally not.

The harder cases involve derivatives that replicate the economics of the underlying security: a call option on a security is typically treated as substantially identical to the security itself for wash-sale purposes, as is a deep in-the-money option, while a far out-of-the-money option may not be.

In high-turnover funds or those using algorithmic systems, wash-sale violations often occur inadvertently — especially when the fund rotates from a losing equity position into a call option on the same equity, into a futures contract on a closely-correlated index, or into an exchange-traded fund holding the same underlying.

Sophisticated funds use tactics such as "doubling down" (buying additional shares of the security and then waiting more than 30 days before selling the original loss lot, to establish a new holding period without triggering § 1091) or transitioning into a non-substantially-identical instrument that supplies similar market exposure (a competitor in the same industry, a different ETF tracking a different index of the same sector, and so on).

Automated pre-trade compliance systems that flag wash-sale risks across all accounts of an investor and across all securities with the same underlying exposure have become a standard feature of institutional trading infrastructure. The compliance task is complicated by the fact that the wash-sale rule applies on a taxpayer-by-taxpayer basis: a sale by a partnership of a security followed by a purchase by a partner of the same security within 30 days does not, by itself, trigger § 1091 at the partnership level (although the related-party rules of § 267 and Treas.

Reg. § 1.1091-1 may produce equivalent results in certain settings).

## **B. Straddles — § 1092**

Section 1092 imposes a series of restrictions on losses, basis, and character recognition with respect to "straddles" — defined under § 1092(c)(1) as "offsetting positions with respect to personal property." Two positions are "offsetting" if there is a substantial diminution of the taxpayer's risk of loss from holding one position by reason of holding one or more other positions, even if those other positions are in different but related properties.

The classic straddle is a simultaneous long and short position in the same or substantially identical securities, but the concept extends to long-and-short pairs in correlated securities, to options-and-underlying pairs, and to other risk-offsetting combinations.

The principal operative rule, in § 1092(a)(1)(A), is that any loss with respect to one or more positions in a straddle is taken into account for any tax year only to the extent that the amount of such loss exceeds the unrecognized gain (if any) with respect to the offsetting positions. Any loss not allowed under this rule is treated as sustained in the succeeding tax year (and is again subject to the same offsetting test in that year). The effect is to defer loss recognition on one leg of a straddle until the gain on the offsetting leg has also been recognized.

Section 263(g) further disallows the deduction of interest expense and carrying charges that are properly allocable to property that is part of a straddle: instead, those amounts must be capitalized into the basis of the property. The interest-and-carrying-charge disallowance is particularly consequential for leveraged hedging strategies, where the cost of carry can be material relative to the gross spread between the long and short legs.

The straddle rules also include holding-period suspension provisions under § 1092(b) and the related regulations: the holding period of the long leg of a straddle is suspended (does not run) while the offsetting short leg is open. This can convert what would otherwise be long-term capital gain into short-term capital gain. A series of safe harbors and identified-straddle elections under § 1092(a)(2) permit certain straddles to be exempted from the loss-deferral rule, although the elections are technical and require precise documentation.

The interaction of § 1092 with the wash-sale rule, the constructive-sale rules, and the § 1256 mark-to-market regime is one of the more intricate areas of trading-activity taxation.

## **C. Section 1256 Contracts and 60/40 Treatment**

Section 1256 prescribes mandatory mark-to-market treatment for a defined class of derivative contracts — "Section 1256 contracts" — comprising regulated futures contracts, foreign currency contracts, non-equity options, dealer equity options, and dealer securities futures contracts.

Under § 1256(a)(1), each Section 1256 contract held by the taxpayer at the close of the tax year is treated as sold for its fair market value on the last business day of the tax year, with any gain or loss taken into account for that tax year (whether or not the contract was actually closed out). The contract's basis is then adjusted to reflect the gain or loss so taken into account, so that the same gain or loss is not recognized again upon actual closing.

Section 1256(a)(3) provides that gain or loss on a Section 1256 contract is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss, regardless of how long the contract was actually held — the so-called "60/40 rule." This is highly favorable relative to the treatment of ordinary short-term trading gains, which are short-term capital gain (taxed at ordinary rates) when held one year or less.

The 60/40 treatment is one of the principal tax-driven reasons that hedge funds whose strategies are amenable to expression in Section 1256 contracts (commodity-trading advisors, managed-futures funds, certain options-arbitrage strategies) prefer those instruments over economically-equivalent instruments outside the § 1256 perimeter.

Section 1256 contracts are reported on Form 6781, separately from other capital-gain transactions. Section 1256 contracts are generally not subject to the wash-sale rule of § 1091 (because the mark-to-market regime obviates the realization-event concept that § 1091 polices), and net § 1256 losses may be carried back up to three years under § 1212(c) to offset § 1256 gains in a prior tax year — a treatment that is more generous than the ordinary capital-loss carryback rules (which do not permit individual carrybacks at all).

#### **D. Constructive Sales — § 1259**

Section 1259, added by the Taxpayer Relief Act of 1997, imposes a constructive-sale regime on certain transactions that economically neutralize an appreciated financial position without formally disposing of it. The provision was directed at the then-common "short against the box" technique, by which a taxpayer holding a long position in an appreciated security would enter into a short sale of the same security to lock in the appreciation while deferring tax recognition.

Section 1259 treats certain such transactions as deemed sales of the underlying position, requiring current recognition of gain.

Under § 1259(a), if a taxpayer enters into a **constructive sale** of an "appreciated financial position," the taxpayer must recognize gain as if the position were sold at its fair market value on the date of

the constructive sale; any gain is taken into account for that tax year, and the basis and holding period of the position are adjusted accordingly.

A constructive sale occurs under § 1259(c)(1) when the taxpayer (i) enters into a short sale of the same or substantially identical property, (ii) enters into an offsetting notional principal contract with respect to the same or substantially identical property, (iii) enters into a futures or forward contract to deliver the same or substantially identical property, or (iv) in the case of an appreciated financial position that is itself a short sale, NPC, or futures or forward contract, acquires the same or substantially identical property.

Several safe harbors are available. The most important is the "closed-transaction" exception of § 1259(c)(3), which provides that a transaction does not produce a constructive sale if the offsetting position is closed before the end of the 30th day after the close of the tax year and the taxpayer holds the original appreciated position throughout the 60-day period beginning on the date the offsetting position was closed.

The exception allows funds to put on short-term hedges across a calendar-year boundary without triggering constructive realization, provided the hedge is unwound and the original position remains exposed for the required holding period.

In practice, many funds rely on basket swaps, customized derivatives, and other structured products that supply hedging or market-exposure benefits while avoiding the "same or substantially identical" thresholds of § 1259 (and of § 1091). The line between a permitted structured product and a constructive sale is fact-intensive and turns on detailed documentation; aggressive structures have been the subject of IRS examination and litigation.

## **E. The § 475(f) Mark-to-Market Election**

Section 475(f) permits an eligible taxpayer to elect mark-to-market accounting for securities or commodities held in connection with a trade or business as a "trader" in such property. The election operates analogously to the § 1256 mark-to-market regime but is broader in scope (it applies to all securities or commodities held by the electing trader, not just to a defined category of derivative contracts) and qualitatively different in tax character (gains and losses are treated as ordinary income or ordinary loss, not as capital gain or loss).

Under § 475(f), securities or commodities held by an electing trader at year end are treated as sold at fair market value on the last business day of the tax year, with any resulting gain or loss recognized as ordinary income or ordinary loss. The principal consequences are three. First, the \$3,000 annual capital-loss limitation of § 1211(b)(1) does not apply, because the losses are not capital losses — full deductibility against ordinary income is available, and excess ordinary losses produce a net operating loss subject to the ordinary NOL carryforward rules.

Second, the wash-sale rule of § 1091 does not apply to electing traders, because the mark-to-market regime obviates the realization-event distinction that § 1091 polices. Third, the constructive-sale rules of § 1259 and the straddle rules of § 1092 are likewise inapplicable in most respects.

The tradeoffs are significant. The principal disadvantage of the election is that all gains, including those on positions held for more than one year, are taxed as ordinary income — forfeiting the long-term capital gain rate (currently a maximum of 20% plus NIIT, for individuals) in favor of the ordinary rate (currently up to 37% plus NIIT).

The election is therefore most attractive for trading strategies that generate predominantly short-term gains (which would be taxed at ordinary rates in any event) and meaningful current losses (which benefit from unlimited deductibility against ordinary income), and least attractive for strategies that generate long-term capital gains (the preferential character of which is forfeited).

### ***1. Eligibility: The "Trader" Threshold***

Eligibility for the § 475(f) election turns on whether the taxpayer qualifies as a "trader in securities" within the meaning of the case law and IRS guidance interpreting the trader-investor distinction. The IRS, in Tax Topic No. 429, applies a three-part facts-and-circumstances test: the taxpayer must (i) seek to profit from daily market movements in prices, not from dividends, interest, or capital appreciation; (ii) conduct trading activity that is substantial; and (iii) carry on the activity with continuity and regularity.

The trader-investor distinction is fact-intensive and not always clear in marginal cases; the principal litigated cases address day traders and individual taxpayers, with hedge funds at the institutional end of the spectrum typically having little difficulty satisfying the test on the merits.

### ***2. Procedural Requirements: Election, Method Change, Revocation***

The § 475(f) election is subject to detailed procedural requirements specified in Rev. Proc. 99-17 and its successors. An existing taxpayer must file an election statement, satisfying Section 5.04 of Rev. Proc. 99-17, no later than the due date (without regard to extensions) of the original federal income tax return for the tax year immediately preceding the year for which the election is being made, attaching the statement either to that return or to a request for extension of time to file that return.

A new taxpayer makes the election by placing a statement satisfying Section 5.04 of Rev. Proc. 99-17 in its books and records no later than two months and 15 days after the first day of the election year, and by attaching a copy of the statement to its original federal income tax return for the election year. Both existing and new taxpayers must, unless the election year is the first year in which the taxpayer owns securities or commodities, file Form 3115 with the federal income tax return for the year of change to effect the accompanying change in method of accounting.

Revocation of the election is governed by Section 24.02 of Rev. Proc. 2025-23 and requires both a notification statement and a Form 3115 to change from the mark-to-market method back to a realization method. A taxpayer that revokes within five years of making the election (or makes a new election within five years of revoking) must file under the nonautomatic change procedures of Rev. Proc. 2015-13 rather than the automatic procedures otherwise available. The five-year rule discourages opportunistic election toggling in response to market conditions.

#### **F. Management Fee Waivers and § 707(a)(2)(A)**

A management fee waiver is an arrangement under which the fund's manager (typically the management company or the general partner) waives the right to receive a portion of the otherwise-payable management fee, in exchange for an additional profits interest in the fund equivalent in present value to the waived fee.

The arrangement, properly structured, converts what would have been compensation income to the manager (taxable as ordinary income with respect to the recipient and deductible by the partnership under § 162) into a profits interest entitling the manager to an additional share of future fund profits (which, when realized as long-term capital gain, is taxed at capital-gain rates). The economic substance is similar but the tax character is materially different.

Management fee waivers have a long pedigree in fund practice but have, since the issuance of proposed regulations under § 707(a)(2)(A) in 2015 (REG-115452-14), been the subject of substantial regulatory and IRS scrutiny. The proposed regulations would treat a fee-waiver arrangement as a **disguised payment** for services — recharacterizing the deemed profits-interest allocations and distributions as ordinary compensation income — if certain factors indicating the absence of "significant entrepreneurial risk" are present.

The 2015 proposed regulations enumerate a non-exclusive list of factors indicating disguised-payment treatment: (i) the arrangement lacks significant entrepreneurial risk; (ii) the service provider holds, or is expected to hold, a transitory partnership interest; (iii) the service provider receives an allocation and distribution in a time frame comparable to that for a nonpartner service provider; (iv) the service provider became a partner primarily to obtain tax benefits unavailable in a third-party service relationship; (v) the value of the provider's continuing partnership interest is small in relation to the allocation and distribution; and (vi) the arrangement provides for different allocations or distributions as to different services subject to materially different levels of entrepreneurial risk.

The One Big Beautiful Bill Act of 2025 amended § 707(a)(2) by striking the phrase "[u]nder regulations prescribed" and replacing it with "[e]xcept as provided" — a change that, the legislative history clarifies, makes § 707(a)(2) self-executing and effective without any regulations. The IRS has

not finalized regulations on disguised payments for services or on disguised sales of partnership interests, although final regulations on disguised sales of property have long been in effect.

After the OBBBA amendment, the provision applies of its own force, and fee-waiver arrangements remain subject to challenge under the statutory text and the principles articulated in the 2015 proposed regulations.

Sound fee-waiver drafting therefore requires careful attention to several elements: ensuring that the waived fees produce profits interests subject to genuine entrepreneurial risk (with real exposure to fund losses, not merely a one-way option on gains); avoiding correlation between the timing of fee waivers and the timing of distributions (which would suggest a disguised payment in time-equivalent form); and complying with the profits-interest safe harbor of Rev.

Proc. 93-27 (with its three conditions concerning predictable income, two-year holding, and publicly traded partnerships). Poorly implemented fee waivers can lead to income recharacterization, accuracy-related penalties, and IRS examination.

### **G. Passthrough Entity Tax (PTET) and SALT Cap Workarounds**

The Tax Cuts and Jobs Act of 2017 imposed a \$10,000 annual limit on the federal income tax deduction for state and local taxes ("SALT") paid by individuals. The limit applied to individual SALT payments but, by its terms, did not apply to SALT paid by a partnership or S corporation at the entity level.

Following IRS Notice 2020-75, in which the Service blessed entity-level State income taxes as deductible by the entity (and therefore as reducing the partner's distributive share of partnership income before passthrough), States began enacting passthrough entity tax ("PTET") regimes — elective entity-level State income taxes whose payment reduces the partnership's federal taxable income and is then credited against the partner's State income tax liability or excluded from the partner's State taxable income.

Approximately thirty-six States and one locality have, as of 2026, enacted PTET regimes of varying design. The basic operative principle is that the partnership elects to pay State income tax at the entity level on a designated portion of its income; the entity's payment is deductible by the entity for federal income tax purposes (reducing the partner's distributive share by the same amount); and the partner receives either a corresponding State tax credit or an exclusion at the State level, neutralizing the effect on State liability while preserving the federal deduction.

The OBBBA temporarily increased the SALT deduction cap to \$40,000 (\$20,000 for married filing separately) beginning in 2025 through tax year 2029, with phaseout for taxpayers with modified adjusted gross income above \$500,000 (\$250,000 for married filing separately), reverting to the

\$10,000 cap in 2030. The OBBBA also preserved the federal deductibility of PTET, so the State-level workaround remains available alongside the temporarily-expanded federal cap.

For high-income fund principals whose individual SALT liability substantially exceeds the federal cap, the PTET election continues to produce meaningful federal tax savings, particularly in high-tax States such as New York, California, New Jersey, and Connecticut.

The PTET regimes vary in design across States; some are mandatory at the entity level subject to election out, some are elective with annual application, and some apply only to a defined class of pass-through entities or income items. Proper modeling of the PTET benefit at the entity level requires attention to (i) the interaction with the partner's individual State residency and apportionment, (ii) the timing of entity-level payments and credits, and (iii) the differing rules for resident and nonresident partners.

For fund management companies organized as partnerships or S corporations and operating in multiple States, the PTET analysis is a routine annual planning item.

## IX. SECURITIES REGULATION OF INVESTMENT VEHICLES

The federal securities laws constitute, alongside the Internal Revenue Code, the second great regulatory overlay that shapes the design of investment vehicles. An entity that is properly designed and operated as a private investment vehicle is one that has been engineered, deliberately and at every stage of its life cycle, to remain outside the most onerous of these regimes.

Six federal statutes are of central importance. The Securities Act of 1933 governs the offer and sale of securities. The Securities Exchange Act of 1934 governs trading markets and the ongoing reporting obligations of public companies. The Investment Company Act of 1940 governs the organization and operation of pooled investment vehicles. The Investment Advisers Act of 1940 governs persons in the business of providing investment advice for compensation. The Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 amended each of the foregoing in respects material to fund formation practice. The State “blue-sky” laws supply a seventh dimension, partially preempted since 1996 by the National Securities Markets Improvement Act.

Three distinct registration regimes operate under these statutes, and they must not be confused. They are independent of one another, they ask different questions, and an entity may be subject to one and exempt from another. *First, registration of the fund as an investment company* under the 1940 Act. The question here is whether the entity that issues the securities (the fund vehicle itself) is an investment company, and if so, whether it must register with the SEC as such. *Second, registration of the manager as an investment adviser* under the Advisers Act. The question here is whether the firm that provides investment advice for compensation — the fund’s manager, typically a separate legal entity from the fund — is itself required to register with the SEC (or with one or more States) on the manager’s own account. *Third, registration of the securities being offered* under the Securities Act. The question here is whether the fund’s issuance of LP interests, membership interests, or shares to investors must be registered with the SEC as a public offering, or instead may rely on an exemption such as Rule 506(b). The three inquiries are logically and legally independent, and a fund formation analysis must address each one separately.

Two further distinctions are foundational and are likewise often confused. The first is between a **public offering** and a **private offering** of securities. A public offering is one that is registered with the SEC under § 5 of the Securities Act (via Form S-1, S-3, N-1A, N-2, or similar), with a prospectus disclosed to the investing public and the offering available without restriction. A private offering — also called a private placement — is one that relies on a statutory or regulatory exemption from § 5 registration, typically Section 4(a)(2) of the Securities Act or Regulation D thereunder, and is restricted to a defined class of qualifying investors. The distinction is about the *offering itself* — about how the securities are sold — not about what the issuer is.

The second distinction is between a **public investment vehicle** and a **private investment vehicle**. A public investment vehicle is an investment company that is registered under the 1940 Act — a mutual fund, an ETF, a closed-end fund, a unit investment trust, or a business development company. A private investment vehicle is a pooled investment vehicle that is excluded from the definition of an investment company under one of the § 3(c) exclusions (most commonly § 3(c)(1) or § 3(c)(7)) and is therefore not registered with the SEC as an investment company at all. The distinction is about the *issuer itself* — about what the fund vehicle is — not about how it sells its securities.

The two distinctions tend to correlate, but they do not necessarily coincide, and the technical separation matters. A public investment vehicle (mutual fund) typically conducts a public offering of its securities — its shares are registered under the Securities Act, sold continuously to the investing public, and offered with a Form N-1A prospectus. A private investment vehicle (hedge fund, PE fund, VC fund) typically conducts a private offering of its interests — it relies on Rule 506(b) or 506(c) of Regulation D and limits investors to accredited investors or qualified purchasers. But the correlation is not airtight. A business development company is a registered investment company under the 1940 Act and yet, before its initial public offering, may have raised its first capital through Reg D private placements. A private fund relying on § 3(c)(7) may, since 2013, conduct a Rule 506(c) offering that uses general solicitation — a feature historically associated only with public offerings. The vehicle classification and the offering classification are independent inquiries that happen, in the ordinary case, to point in the same direction.

The exposition is organized around the four operative questions every fund formation lawyer must answer before structure is finalized. *First*, what counts as a security, such that the offer and sale of the fund's interests implicates the federal securities laws at all (Subpart IX.A). *Second*, what are the consequences if the fund itself is an "investment company" within the meaning of the 1940 Act, and how does the fund qualify for an exclusion (Subparts IX.B and IX.C). *Third*, how does the fund offer its interests without registration under the Securities Act, and which Regulation D safe harbor applies (Subpart IX.D). *Fourth*, what is the regulatory status of the fund's manager under the Advisers Act, and what registration obligations follow (Subpart IX.E). The remaining subparts address Section 12(g) of the Exchange Act and the holder-of-record problem (IX.F) and the State blue-sky overlay (IX.G).

## **A. The Securities Act of 1933 and What Counts as a Security**

Section 5 of the Securities Act is the foundational provision of U.S. securities regulation. It provides that, subject to specified exemptions, no person may offer or sell a security in interstate commerce unless a registration statement is in effect with respect to the security. The penalty for non-

compliance is severe: under § 12(a)(1), any person who offers or sells a security in violation of § 5 is liable to the purchaser for rescission, with interest, less any income received on the security. Section 5 thus operates as the gateway provision: every offering of a security is either registered (the public-offering route) or exempt (the private-placement route).

The threshold question is therefore whether the instrument being offered is a “security” within the meaning of § 2(a)(1) of the Securities Act, which supplies a long enumerated list followed by a residual catch-all “investment contract” category. The enumerated items — “any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement,” and so on — capture most conventional financial instruments. The residual investment-contract category is the category of greatest doctrinal interest, because it captures arrangements that are not formally cast as conventional securities but that nevertheless resemble them in economic substance.

The canonical formulation of the investment contract test is the four-part **Howey** test of *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946): an arrangement is an investment contract if there is (i) an investment of money, (ii) in a common enterprise, (iii) with an expectation of profits, (iv) to be derived from the efforts of others. Each prong has been the subject of substantial case-law development. The “common enterprise” prong has produced a divergence among the Federal Circuits, with some adopting “horizontal commonality” (pooling of investor funds and pro-rata sharing of profits and losses) and others adopting “vertical commonality” (linkage of investor fortunes to the promoter’s efforts). The “expectation of profits” prong was elaborated in *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975), distinguishing between the consumption motive and the investment motive. The “efforts of others” prong was elaborated in *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973), which adopted the formulation that the relevant efforts must be “the undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.”

### **1. Limited Partnership Interests**

Limited partnership interests in private investment funds are universally treated as securities. The conclusion is overdetermined: limited partnership interests are explicitly enumerated in § 2(a)(1) as “certificates of interest or participation in any profit-sharing agreement,” and they satisfy Howey on their facts (limited partners by definition contribute capital to a common enterprise managed by the general partner, with an expectation of profits derived from the GP’s investment efforts). The Supreme Court confirmed the treatment in dictum in Howey itself, and no contrary authority of significance exists. For practical purposes, every limited partnership interest in a private fund context is a security.

## **2. LLC and General Partnership Interests: When Management Rights Defeat Security Status**

The analysis is materially different — and materially more nuanced — for interests in entities whose members or partners are formally vested with management authority. Two categories matter: interests in member-managed LLCs and interests in general partnerships. In neither case is the Howey “efforts of others” prong automatically satisfied, because the holder is, on paper, responsible for the relevant efforts. Whether the interest is in fact a security depends on the substance of the arrangement, not its form.

The seminal authority is *Williamson v. Tucker*, 645 F.2d 404 (5th Cir. 1981), which addressed the question whether interests in a joint venture formally structured as a general partnership constituted securities. The Fifth Circuit held that the formal allocation of management rights to the holder creates a strong presumption that the interest is not a security, but that the presumption may be rebutted if the investor demonstrates that the interest in fact functions as a passive investment. The court identified three rebuttal showings, any one of which suffices to establish security status:

- the partnership or LLC agreement leaves so little power in the hands of the investor that the arrangement in fact distributes power as would a limited partnership;
- the investor is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his managerial powers; or
- the investor is so dependent on the unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace him or otherwise exercise meaningful partnership powers.

Absent any of these showings, the partnership or member-managed LLC interest is presumed not to be a security. The classic non-security case is the closely held operating business, formed as an LLC or general partnership, in which two or three founders contribute capital and labor and jointly run the business. Each founder has equal information, equal voice, equal exit rights, and equal managerial responsibility; none is dependent on the efforts of the others in the Howey sense. Examples include a two-doctor medical practice formed as an LLC, a three-partner real estate development firm structured as a general partnership, a family-run restaurant LLC in which all members work in the business, and a professional services LLC of equal owner-operators. In each case, the members are the enterprise, not investors in the efforts of someone else, and their interests are not securities.

Conversely, where the formal allocation of management rights is nominal — where most members are passive capital providers and a single member or a small group exercises de facto control — the interests are likely to be held securities notwithstanding the formal labels. The cases are heavily fact-specific. See generally *SEC v. Merchant Capital, LLC*, 483 F.3d 747 (11th Cir. 2007) (general partnership interests held to be securities where investors had no practical ability to exercise their formal management rights); *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003) (LLC interest held not a security where the investor in fact participated meaningfully in management). For a manager-

managed LLC, by contrast, the analysis is uniformly that the interest is a security: members have no management rights as such, and the manager is the person whose efforts produce profits.

For purposes of fund formation, the practical guidance is straightforward. Fund interests held by passive investors — limited partners, non-managing members of manager-managed LLCs, holders of preferred stock — are securities. Interests in operating LLCs and general partnerships whose members in fact run the business are typically not securities. Management-company LLCs in which the partners are the working principals of the firm and jointly direct operations generally fall in the non-security category, though the characterization should be confirmed on the facts of each engagement. Stock of a corporation, by enumeration in § 2(a)(1) and under *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), is always a security regardless of the holder's role.

## **B. Consequences of Qualifying as an Investment Company**

Before turning to the question of when an entity qualifies as an investment company under § 3(a) of the 1940 Act and how the various exclusions operate (Subpart IX.C below), it is useful to understand at the outset why so much structural ingenuity is devoted to remaining outside the 1940 Act's coverage. An entity that registers as an investment company — or that is required to register and has failed to do so — is subject to a regulatory regime far more intrusive than the disclosure-based regimes of the Securities Act and the Exchange Act. The 1940 Act regulates the registrant's capital structure, governance, transactions with affiliates, advisory contracts, custody arrangements, pricing methods, redemption rights, recordkeeping, compliance program, and external audit relationships. Each of these areas imposes substantive operating restrictions that are flatly incompatible with the customary operating model of a private investment fund. And the consequence of being subject to registration without having registered is not merely the prospective burden of compliance: under § 47(b) of the 1940 Act, contracts made in violation of the Act may be voidable, and transactions effected by an unregistered investment company are exposed to rescission and damages liability.

The principal obligations imposed on a registered investment company are summarized below. The list is illustrative, not exhaustive.

- **Capital-structure limitations under § 18.** Section 18 prohibits an open-end fund from issuing senior securities other than bank borrowings and limits any such borrowing to a level that maintains 300% asset coverage at the time the borrowing is incurred. The 300% test translates to a 1:2 debt-to-equity ratio: total assets must equal at least three times senior debt, which means that for every \$1 of borrowing the fund must hold \$3 of total assets (\$2 of which is equity). For a closed-end fund, § 18 permits one class of senior securities representing indebtedness subject to the same 300% coverage test and one class of preferred stock subject to a 200% coverage test. Cross-class senior security structures are generally prohibited. The substantive consequences are profound: a registered fund cannot

run the levered strategies typical of hedge funds or the highly levered structures typical of credit and CLO managers without operating under § 18's binding constraint.

- **Transactions-with-affiliates prohibitions under §§ 17(a), 17(d), and 17(e).** Section 17(a) prohibits an “affiliated person” of a registered investment company (defined broadly to include officers, directors, the adviser, 5% holders, and entities under common control) from selling property to or purchasing property from the fund. Section 17(d) and Rule 17d-1 prohibit joint transactions between the fund and an affiliated person, including co-investments by the adviser and the fund in the same portfolio company absent a Commission exemptive order. Section 17(e) restricts the compensation that may be paid to an affiliated person acting as agent or broker for the fund. The practical consequence is that cross-trades between funds in the same complex, principal transactions with the adviser, and many co-investment arrangements that are routine in private fund practice are unavailable to a registered fund without case-by-case Commission relief.
- **Board composition under § 10(a).** Section 10(a) requires that at least 40% of the board of directors of a registered investment company consist of persons who are not “interested persons” within the meaning of § 2(a)(19), and in practice — because § 15(c) and Rule 10f-3 (among others) require that certain matters be approved by a majority of independent directors — most fund complexes maintain boards on which a majority (often supermajority) of the directors are independent. The definition of “interested person” extends well beyond formal affiliation and is the source of significant compliance attention.
- **Pricing and valuation under § 22(c) and Rule 22c-1.** Rule 22c-1 requires that open-end funds price their shares for purchase, redemption, and exchange at the net asset value next computed after receipt of the order (the “forward pricing” requirement), and requires daily computation of NAV in accordance with prescribed methodologies. The valuation rules under Rule 2a-5 (adopted in 2020) prescribe the methodology by which fair-value determinations for portfolio securities lacking readily available market quotations must be made. These rules collectively dictate the timing and methodology of the fund’s daily operations.
- **Advisory contract requirements under § 15.** Section 15 requires that the fund’s advisory contract be approved initially by a majority of outstanding voting securities of the fund and annually thereafter (after the first two years) by either the board (including a majority of independent directors) or shareholders. Section 15(c) requires the board, in connection with annual approval, to evaluate specified factors (the so-called Gartenberg factors) bearing on the reasonableness of the advisory fee. Section 15(a)(4) prohibits the assignment of the advisory contract, which has been read to terminate the contract upon any change of control of the adviser — a constraint of significant relevance to M&A transactions involving fund advisers.
- **Custody requirements under § 17(f) and Rule 17f-2.** Section 17(f) and the rules thereunder require a registered fund to maintain custody of its securities and other assets with a qualified bank custodian, with limited exceptions for self-custody (subject to enhanced controls) and for non-U.S. securities held with eligible foreign custodians under Rule 17f-5.

The custody rules are highly prescriptive and significantly more demanding than the analog custody rule under the Advisers Act applicable to unregistered private funds.

- **Distribution and Rule 12b-1 fees.** Rule 12b-1 governs the payment of fund assets for distribution activities, including a board-approved written plan, annual board review, and shareholder vote requirements. Distribution arrangements that would be straightforward for a private fund (placement agent fees, marketing expenses) are subject to detailed substantive constraints when paid by a registered fund.
- **Recordkeeping, reporting, and disclosure.** A registered fund is required to file an initial registration statement on Form N-1A (open-end), N-2 (closed-end), or N-4 (variable insurance product); annual and semi-annual reports to shareholders; periodic portfolio disclosures on Forms N-PORT and N-CEN; reports of proxy voting on Form N-PX; and a long list of additional filings. Recordkeeping requirements under § 31 and Rule 31a-1 prescribe in detail the books and records that must be maintained.
- **Compliance program under Rule 38a-1.** Rule 38a-1 requires the fund to adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws, to designate a chief compliance officer reporting to the board, and to conduct annual reviews of the compliance program.
- **Redemption obligations under § 22(e).** Open-end funds are required to redeem outstanding shares on demand within seven days of receipt of a redemption request, with very narrow exceptions. The result is a structural mismatch with any illiquid investment strategy — a constraint that is the principal reason that private equity, venture, real estate, and credit funds are organized as private funds outside the 1940 Act rather than as registered open-end funds.

Taken together, these provisions render the registered investment company form unsuitable for any investment strategy involving leverage above modest levels, illiquid investments, transactions with affiliates, performance-based compensation outside the narrow confines of § 205, or operating flexibility of the kind taken for granted in private fund practice. The avoidance of 1940 Act registration is, in consequence, the single most important structural objective in private fund formation, and the §§ 3(c)(1) and 3(c)(7) exclusions (Subpart IX.C below) are the structural foundation upon which the entire private fund industry rests.

## C. The Investment Company Act of 1940: Definition, Tests, and Exclusions

For private investment vehicles, the central and overriding objective of 1940 Act analysis is to remain outside the Act's reach. The analysis proceeds in two steps. First, does the entity meet the definition of an "investment company" under § 3(a)? Second, if so, does an exclusion under § 3(c) apply?

### 1. The Definition of "Investment Company"

Section 3(a)(1) supplies three independent definitions of "investment company." Any one of them suffices to bring an entity within the Act's scope. The three tests, in order of practical importance:

- **The "primarily engaged" test (§ 3(a)(1)(A)).** An entity is an investment company if it is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities. This is a facts-and-circumstances test that examines, among other things, the entity's historical development, its public representations, the activities of its officers and directors, the nature of its assets, and the source of its income — the so-called Tonopah factors from *In the Matter of Tonopah Mining Co. of Nev.*, 26 S.E.C. 426 (1947).
- **The face-amount certificate test (§ 3(a)(1)(B)).** An entity is an investment company if it issues face-amount certificates of the installment type. A "face-amount certificate" is a category rooted in the 1920s: a contract under which the issuer promises to pay a stated ("face") amount to the holder at a fixed maturity date, with the holder paying the issuer in installments before maturity. The product is economically a long-dated savings instrument with a fixed-income payoff and was sold widely to retail investors before mutual funds became the dominant retail investment product. The 1940 Act preserved the category as a distinct subset of investment companies because of the special abuses associated with face-amount-certificate companies during the pre-1940 era. The category survives in §§ 28 and 29 of the 1940 Act (prescribing capital, reserve, and investment requirements for face-amount-certificate companies), but the number of currently registered face-amount-certificate companies is in the low single digits and the category has no contemporary relevance to fund formation. It is addressed here only for completeness of the § 3(a)(1) definitional structure.
- **The 40% test (§ 3(a)(1)(C)).** An entity is an investment company if it is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities and owns or proposes to acquire "investment securities" having a value exceeding 40% of the value of the entity's total assets (exclusive of Government securities and cash items) on an unconsolidated basis. The definition of "investment securities" in § 3(a)(2) excludes Government securities, securities issued by employees' securities companies, and (critically) securities issued by majority-owned subsidiaries of the entity that are not themselves investment companies and are not relying on §§ 3(c)(1) or 3(c)(7) for their own exclusion.

The 40% test is, in practice, the binding constraint for most operating businesses that hold financial assets. A holding company that owns 80% subsidiaries engaged in operating businesses is

generally outside the test because the subsidiary securities are excluded from the numerator. A holding company that holds a portfolio of minority equity stakes, however, may readily exceed the 40% threshold and require analysis under the Act's exemptions. The SEC's Rule 3a-1 supplies a safe harbor for certain asset-composition profiles, and Rule 3a-2 supplies a one-year transient investment company safe harbor for an issuer that finds itself inadvertently above the 40% threshold.

**Table IX.C-1 – When an Entity Is an Investment Company**

Test	When Triggered	Practical Application
§ 3(a)(1)(A) – “Primarily Engaged” Test	Entity is or holds itself out as engaged primarily in investing, reinvesting, or trading in securities. Tonopah factors examined: historical development; public representations; activities of officers and directors; nature of assets; source of income.	Catches entities whose actual conduct or self-presentation is that of an investment manager, even if asset thresholds are not crossed.
§ 3(a)(1)(B) – Face-Amount Certificate Test	Entity issues face-amount certificates of the installment type.	Historical category, rarely encountered in modern practice.
§ 3(a)(1)(C) – 40% Test	Investment securities exceed 40% of total assets (excluding Government securities and cash). Majority-owned operating subsidiaries are excluded from the numerator under § 3(a)(2).	The binding constraint for most holding companies. Triggered by portfolios of minority equity stakes; avoided by structures owning 80%+ operating subsidiaries.
Rule 3a-1 Safe Harbor	Not more than 45% of total assets and not more than 45% of net income from investment securities (and other tests).	Asset-composition safe harbor for operating companies holding incidental securities portfolios.
Rule 3a-2 Transient Issuer	Issuer with bona fide intent to become non-investment-company within one year may rely on this exemption once every three years.	Used for entities in transition (e.g., post-IPO companies; entities redeploying capital).

## **2. §§ 3(c)(1) and 3(c)(7): The Private Fund Exclusions**

Of the various exclusions enumerated in § 3(c) of the 1940 Act, two are indispensable to private fund practice: § 3(c)(1) and § 3(c)(7).

Section 3(c)(1) excludes any issuer whose outstanding securities (other than short-term paper) are beneficially owned by **not more than one hundred persons** and that is not making and does not propose to make a public offering of its securities. The 100-person count is the structural foundation of the “private fund.” Section 3(c)(1) is available regardless of investor wealth, but the 100-person count is rigorously enforced — exceeding it by even one investor causes the entity to lose the

exclusion and to become an unregistered investment company in violation of the Act. Beneficial ownership is generally counted as one per record holder, but Section 3(c)(1) (A) requires look-through to the beneficial owners of certain holders that are themselves investment companies, and the “knowledgeable employee” exclusion under Rule 3c-5 excludes certain employees of the adviser from the count. In a fund-of-funds context, where one of the investors is itself a 3(c)(1) fund holding 10% or more of the lower-tier fund, look-through to the upper fund’s beneficial owners is required.

Section 3(c)(7) (added in 1996 by NSMIA) excludes any issuer whose outstanding securities are owned exclusively by **qualified purchasers** and that is not making and does not propose to make a public offering. A “qualified purchaser” is defined in § 2(a)(51) and generally includes (i) natural persons owning not less than \$5 million in “investments” as defined in Rule 2a51-1; (ii) family-owned companies owning not less than \$5 million in investments; (iii) trusts whose trustees and settlors are qualified purchasers; and (iv) entities, acting for their own account or for the account of other qualified purchasers, that in the aggregate own and invest on a discretionary basis not less than \$25 million in investments. Section 3(c)(7) imposes no numerical cap on investor count; the operative constraint is the qualified-purchaser eligibility threshold for every investor.

For institutional-quality funds with high investor minimums (typically \$5 million and above), § 3(c)(7) is preferred. For funds targeting a smaller investor base of accredited but not qualified-purchaser-level individuals, § 3(c)(1) is the necessary vehicle. The two exclusions may be combined in master-feeder structures: a Cayman master fund relying on § 3(c)(7), with U.S. and offshore feeders that may rely on § 3(c)(1), § 3(c)(7), or both, is the industry-standard architecture for funds accepting both U.S. taxable and U.S. tax-exempt and non-U.S. investors.

The penalty for inadvertent exceedance of the 100-person limit under § 3(c)(1), or for inadvertent admission of a non-qualified-purchaser under § 3(c)(7), is loss of the exclusion and exposure to the 1940 Act’s registration requirements — a catastrophic outcome that requires close attention to investor counts and qualifications throughout the fund’s life.

### ***3. Other Exclusions of Practical Importance***

Several other exclusions are of practical importance for specific strategies. Section 3(c)(5)(C) excludes entities “primarily engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate” — the foundation of the mortgage REIT and many real estate credit fund structures. Section 3(c)(5)(A) and (B) cover certain factoring and consumer-finance entities. Section 3(c)(6) addresses holding companies of § 3(c)(5) entities. Section 3(c)(11) excludes qualified employee benefit plans. Real estate equity funds typically rely on the SEC’s longstanding interpretive position that a fund engaged exclusively in the direct acquisition and ownership of real estate is not an investment company at all, since real estate is not a security and the fund therefore fails the threshold “engaged in the business of investing in securities” requirement of § 3(a)(1).

**Table IX.C-2 – Choosing Among the 1940 Act Exclusions**

<b>Exclusion</b>	<b>Investor Eligibility</b>	<b>Numerical Limit</b>	<b>Typical Use Case</b>
§ 3(c)(1)	No statutory wealth threshold; in practice limited to accredited investors by Securities Act Rule 506.	Not more than 100 beneficial owners.	Smaller funds; emerging-manager funds; funds accepting friends-and-family or HNW investors below QP thresholds.
§ 3(c)(7)	Qualified purchasers only (\$5M for individuals; \$25M for entities).	No statutory limit; in practice limited by § 12(g) of the Exchange Act to fewer than 2,000 holders of record.	Institutional-grade funds; hedge funds with HNW/UHNW investor base; preferred where investor minimums are at or above \$5M.
§ 3(c)(5)(C)	No statutory investor restriction (but Securities Act exemption still required).	No numerical limit (but other regulatory regimes apply).	Mortgage REITs; real estate credit funds; mortgage-backed securities investors.
Direct real estate (interpretive)	No statutory investor restriction.	No numerical limit.	Funds investing directly in real property rather than in mortgages or REIT securities.
Rule 3a-7	Various structural and rating-agency requirements.	Various.	Structured finance vehicles (CLOs, ABS issuers) holding eligible assets.

#### **D. Securities Act Registration Exemptions**

The mechanic of the Securities Act bears restating clearly. Section 5 prohibits any offer or sale of a security in interstate commerce unless either (a) a registration statement covering the security is in effect or (b) the offer and sale qualifies for an exemption from registration. There is no third path: every transaction in a security must travel one of these two routes.

A private investment vehicle, in principle, could register its securities. Nothing in the Securities Act prohibits the registration of LP interests or LLC membership interests in a private fund. In practice, however, no private fund does so. The reasons are practical rather than legal: registration would require the preparation of a full prospectus with line-item disclosure of investment strategy, fee structure, and risk factors; it would subject the fund to continuous Exchange Act reporting under § 15(d) of the Exchange Act; it would create securities that are freely tradable by the holders (the very feature private funds are designed to avoid, both because illiquid investments require investor lock-

ups and because §§ 3(c)(1) and 3(c)(7) of the 1940 Act condition the private-fund exclusions on the absence of a public offering); and it would impose administrative costs and disclosure burdens that are economically prohibitive for a vehicle whose securities are sold once to a small investor base. The registered investment company form under the 1940 Act exists precisely for issuers prepared to undertake those burdens; the private fund is, by design, the alternative for issuers that are not.

Private investment vehicles therefore, as a matter of universal industry practice rather than legal compulsion, rely on a registration exemption. The principal exemptions are Section 4(a)(2) of the Securities Act and the related safe harbors supplied by Regulation D under Rules 504, 506(b), and 506(c). The remainder of this Subpart addresses these exemptions in turn.

### **1. Section 4(a)(2) – The “Sophisticated Investor” Exemption**

Section 4(a)(2) — also commonly described as the *statutory private-placement exemption* or the *sophisticated investor exemption* — exempts from § 5 “transactions by an issuer not involving any public offering.” The exemption turns not on the characteristics of the security or the size of the offering but on the nature of the offerees. The seminal interpretation is the Supreme Court’s decision in *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953), which held that the exemption turns on whether the offerees are persons who “are shown to be able to fend for themselves” — that is, persons whose access to information of the type that would be available in a registration statement, and whose sophistication, are sufficient to obviate the need for the disclosure protections of registration.

The Ralston Purina standard remains the operative test for § 4(a)(2) offerings that do not fit within Regulation D. In practice, fund offerings rely primarily on Rule 506 of Regulation D (Subpart IX.D.2 below) because the safe-harbor character of Rule 506 provides considerably more predictability than reliance on § 4(a)(2) standing alone. But Rule 506(b) is itself a safe harbor under § 4(a)(2), and the Ralston Purina sophistication principles continue to inform the design of fund offering practices, particularly the requirement of a substantive pre-existing relationship with each offeree under Rule 506(b).

### **2. Regulation D – The Principal Safe Harbors**

Regulation D (17 C.F.R. §§ 230.500 – 230.508) supplies a series of safe harbors under § 4(a)(2) and § 3(b) of the Securities Act. The three currently operative safe harbors are Rules 504, 506(b), and 506(c) (the former Rule 505 was repealed in 2017). Of these, Rules 506(b) and 506(c) are the safe harbors of relevance to private investment vehicles.

**Rule 506(b) – Traditional private placement (no general solicitation).** Rule 506(b) permits an unlimited offering amount to an unlimited number of accredited investors (as defined in Rule 501(a)) and to up to 35 non-accredited investors who meet a sophistication standard substantially

comparable to Ralston Purina. The principal restriction is that the offering may not involve general solicitation or general advertising within the meaning of Rule 502(c) — a restriction that effectively requires the issuer to have a substantive pre-existing relationship with each offeree before the offering is made. Rule 506(b) is the dominant safe harbor for private fund offerings.

**Rule 506(c) — General solicitation permitted; accredited-only.** Rule 506(c), added in 2013 in response to the JOBS Act of 2012, permits an offering to be made by means of general solicitation provided that (i) all purchasers are accredited investors and (ii) the issuer takes “reasonable steps to verify” their accredited-investor status (a more demanding standard than the self-certification permitted under Rule 506(b)). Rule 506(c) was widely expected to displace Rule 506(b) for fund offerings, but its practical adoption has been more limited than anticipated: the verification requirement is more burdensome, the use of general solicitation creates 1940 Act issues for funds relying on § 3(c)(1) or § 3(c)(7) (the no-public-offering element of those exclusions), and general solicitation interacts unfavorably with the Advisers Act marketing rule.

**Rule 504 — Small offerings up to \$10 million.** Rule 504 permits an offering of up to \$10 million in any twelve-month period, subject to a more limited integration analysis. Notably, Rule 504 imposes no statutory investor-eligibility requirements: there is no accredited-investor requirement, no qualified-purchaser requirement, no sophistication standard, and no investor numerical cap. The issuer may sell to any purchaser, accredited or not. The trade-off is twofold. First, Rule 504 is not available to Exchange Act reporting companies, investment companies, or blank-check companies (with the consequence that pooled investment vehicles relying on the §§ 3(c)(1) or 3(c)(7) exclusions can use Rule 504 only on a careful structural reading). Second, Rule 504 is not a covered-security safe harbor under NSMIA, so State blue-sky registration or exemption is required in every State of offer. Rule 504 is rarely used in fund formation because the offering cap is too low to support a meaningful institutional fund, but it is occasionally employed for ancillary vehicles such as small co-investment SPVs or for managers raising modest amounts before scaling up.

### ***3. General Solicitation and General Advertising***

Because the distinction between Rule 506(b) and Rule 506(c) turns entirely on whether the offering involves general solicitation or general advertising, the operative content of those terms warrants close attention. The terms are defined functionally rather than by enumeration: Rule 502(c) describes general solicitation and general advertising as including, but not limited to, (i) any advertisement, article, notice, or other communication published in any newspaper, magazine, or similar medium or broadcast over television or radio and (ii) any seminar or meeting whose attendees have been invited by any general solicitation or general advertising. The category is broad and the SEC has consistently interpreted it expansively.

Activities clearly constituting general solicitation include: published advertisements (print, online, social media); mass email or mass postal mailings to recipients without a pre-existing relationship; cold calling telephone campaigns; press releases announcing the offering; investor presentations and pitch decks distributed without screening; appearances on financial news programs to promote a fund's offering; publicly accessible websites describing the offering and inviting investment; Twitter or LinkedIn posts that are visible to non-followers and invite investment; and any public-facing seminar, conference, or networking event held to attract investors.

Activities that do not constitute general solicitation, by contrast, include communications with persons with whom the issuer or its placement agent has a *substantive pre-existing relationship*. A pre-existing relationship is one established before the commencement of the offering; a substantive relationship is one in which the issuer (or its agent) has sufficient information about the prospective investor to evaluate the investor's financial circumstances and sophistication. The SEC has long taken the position, through a sequence of no-action letters culminating in the 2015 Citizen VC, Inc. letter, that a properly operated online investor portal with a meaningful pre-screening questionnaire can establish a substantive pre-existing relationship even with persons not previously known to the issuer. Beyond the pre-existing-relationship doctrine, communications restricted to existing limited partners of the same sponsor's prior funds, communications with consultants and intermediaries acting for institutional investors, and responses to unsolicited inquiries are generally not general solicitations.

The 2020 SEC amendments codified a series of "demo-day" safe harbors under Rule 148, providing that certain communications at sponsored events held by colleges, universities, government agencies, incorporated nonprofits, and angel-investor groups will not constitute general solicitation if specified conditions are met. These safe harbors are of limited utility in institutional fund formation but are important in early-stage venture practice.

The practical consequence of the general-solicitation classification is binary. If the offering does not involve general solicitation, the issuer may rely on Rule 506(b), which permits up to 35 non-accredited (but sophisticated) purchasers and permits the issuer to rely on the investor's own representation of accredited-investor status. If the offering does involve general solicitation, the issuer must rely on Rule 506(c), which limits purchasers to accredited investors only and requires the issuer to take reasonable steps to verify accredited status (typically through third-party verification by an accountant or registered broker-dealer, or by review of W-2s, tax returns, brokerage statements, or comparable documentation). There is no intermediate position. An issuer that engages in any general solicitation in connection with the offering forfeits the Rule 506(b) safe harbor and the related ability to accept non-accredited purchasers or rely on self-certification, even if no non-accredited purchaser is actually admitted to the offering.

A separate but related point: § 4(a)(2) of the Securities Act, the statutory exemption underlying Rule 506(b), has been read by the courts to prohibit general solicitation as a constitutive element of "not

involving any public offering.” The Ralston Purina standard requires that offerees be persons who are able to fend for themselves, and a public solicitation by definition reaches persons whose ability to do so cannot be assessed in advance. Rule 506(c), although a Reg D safe harbor under § 4(a)(2), was created by Congress’s express direction in § 201(a) of the JOBS Act, which directed the SEC to lift the general-solicitation ban in Rule 506 offerings limited to accredited investors. The statutory foundation for general solicitation in private offerings is therefore narrow: it exists in Rule 506(c) by act of Congress, but not in § 4(a)(2) standing alone, and not in Rule 504 to the extent the issuer is offering in a State that prohibits general solicitation under State blue-sky law.

The accredited investor categories under Rule 501(a) include: individuals with net worth exceeding \$1 million (excluding primary residence) or income exceeding \$200,000 (\$300,000 jointly with a spouse) in each of the prior two years with a reasonable expectation of the same in the current year; entities with total assets exceeding \$5 million not formed for the purpose of acquiring the securities offered; entities whose equity owners are all accredited investors; banks, insurance companies, and certain other institutional investors; and (since the SEC’s 2020 amendments) certain “knowledgeable employees” of a private fund within the meaning of Rule 3c-5 of the 1940 Act, as well as natural persons holding designated professional certifications (currently Series 7, 65, and 82) in good standing.

**Table IX.D-1 — Comparison of Securities Act Exemptions for Private Fund Offerings**

Exemption	§ 4(a)(2)	Rule 506(b)	Rule 506(c)	Rule 504
Offering Size	Unlimited	Unlimited	Unlimited	\$10M / 12 mos.
Investor Eligibility	“Able to fend for themselves” (Ralston Purina)	Unlimited accredited investors; up to 35 sophisticated non-accredited investors	Accredited investors only	No investor-eligibility limit (but State law may apply)
General Solicitation	Prohibited	Prohibited (Rule 502(c))	Permitted	Permitted in some States
Verification of Status	N/A (qualitative test)	Self-certification permitted	“Reasonable steps to verify” required	N/A
NSMIA Preemption (Covered Security)	No	Yes	Yes	No (State registration required)
Form D Filing	Not required	Required within 15 days of first sale	Required within 15 days of first sale	Required within 15 days of first sale

Exemption	§ 4(a)(2)	Rule 506(b)	Rule 506(c)	Rule 504
Bad-Actor Disqualification (Rule 506(d))	N/A	Applies	Applies	N/A (separate Rule 504(b)(3) disqualification)
Typical Private Fund Use	Backup / non-Reg D analysis	Standard for traditional private placements	Used where public marketing desired	Rare; small SPVs

#### **4. Form D, Bad-Actor Disqualifications, and Integration**

A point that is often misunderstood by issuers approaching their first private offering bears emphasis at the outset of this subsection. An exemption from registration under the Securities Act is an exemption from the substantive registration requirements of § 5 — the obligation to file a registration statement, to undergo SEC staff review, to produce and deliver a statutory prospectus, and to remain subject to post-effective amendment and ongoing Exchange Act reporting under § 15(d). It is not an exemption from regulation generally, and it is not an exemption from notice-filing or anti-fraud obligations. Even an offering that is fully exempt from registration is subject to a number of regulatory obligations: a notice filing on Form D with the SEC; notice filings with State securities regulators in each State of investor residence; ongoing anti-fraud liability under Rule 10b-5 and § 17(a) of the Securities Act, both of which apply to exempt offerings no less than to registered offerings; the bad-actor disqualification rule under Rule 506(d); the integration framework under Rule 152; and, in the case of pooled investment vehicles, the marketing-rule restrictions of Rule 206(4)-1 under the Advisers Act and the no-public-offering condition of the §§ 3(c)(1) and 3(c)(7) exclusions. The exemption removes the registration burden; it does not free the issuer from disclosure of the offering to regulators or from the substantive duties owed to investors.

Each Rule 506 offering requires the filing of Form D with the SEC within 15 days after the first sale of securities in the offering. The Form D discloses the identity of the issuer, the persons related to the issuer (executive officers, directors, promoters, and 10% beneficial owners), the exemption claimed (Rule 504, 506(b), or 506(c)), the type of securities offered, the offering size, the use of proceeds in summary, and (for fund offerings) the identification of the relevant § 3(c) exclusion. The filing is made electronically through the SEC's EDGAR system. The information disclosed on Form D is publicly available, and it permits the Commission staff to monitor private offering activity in the aggregate, identify trends, and pursue enforcement against individual issuers when warranted. Most States separately require a notice filing of the same Form D (or a State-specific cover sheet accompanying the Form D) together with a filing fee. The Form D filing is administrative rather than substantive in content, but its timely filing is a condition of certain related rules (including the State notice-filing structure and certain integration safe harbors) and is itself a meaningful compliance obligation.

Rule 506(d) — the “bad actor” disqualification rule added in 2013 — disqualifies issuers from reliance on Rule 506 if certain “covered persons” (the issuer, its directors and officers, certain affiliates, persons compensated for soliciting purchasers, and 20% beneficial owners) have suffered specified disqualifying events such as criminal convictions related to securities, court injunctions, regulatory orders, or SEC cease-and-desist orders within the prescribed look-back periods. The bad-actor analysis is a routine due-diligence item in fund formation; certifications from each covered person are typically obtained at organizational closing, and the Form D itself asks the issuer to confirm that no disqualifying event has occurred.

The integration doctrine — historically a complex five-factor analysis under former Rule 502(a) — was substantially simplified by the SEC’s 2020 amendments codified in Rule 152. Rule 152 supplies a general principle that offers and sales will not be integrated if, based on the particular facts and circumstances, the issuer can establish that each offering complies with the requirements of the exemption being relied on, together with four non-exclusive safe harbors. The most important safe harbor in fund practice is the 30-day separation safe harbor in Rule 152(b)(1): offerings made more than 30 calendar days before commencement of any other offering, or more than 30 calendar days after termination or completion of any other offering, will not be integrated with that other offering. The current Rule 152 framework has substantially reduced integration risk in modern fund practice.

## **E. The Investment Advisers Act of 1940**

The Investment Advisers Act of 1940 governs persons in the business of providing investment advice for compensation. Its central operative provision is § 203, which requires registration with the SEC of any “investment adviser” (a defined term under § 202(a)(11)) unless an exclusion from the definition or an exemption from registration applies. The Act’s 2010 amendments by Title IV of Dodd-Frank fundamentally restructured the regulatory framework applicable to advisers to private funds: the prior “private adviser exemption” of former § 203(b)(3) (which exempted advisers with fewer than fifteen clients) was repealed, and most fund advisers either register with the SEC under § 203 or rely upon one of the new “exempt reporting adviser” exemptions described below.

### **1. Who Is an Investment Adviser?**

Section 202(a)(11) defines an investment adviser as *any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities*. The three operative elements — (i) for compensation, (ii) in the business of advising others, and (iii) as to securities — must each be satisfied. The SEC’s interpretive guidance under Release No. IA-1092

(1987) elaborates each element, and the “in the business” element in particular has been the subject of substantial Commission no-action letter and enforcement guidance.

Several statutory exclusions remove specified categories of persons from the definition: banks and bank holding companies (§ 202(a)(11)(A)); lawyers, accountants, engineers, and teachers giving incidental advice (§ 202(a)(11)(B)); broker-dealers receiving no special compensation for advice (§ 202(a)(11)(C)); publishers of bona fide newspapers and other publications (§ 202(a)(11)(D)); and family offices satisfying the requirements of Rule 202(a)(11)(G)-1. Within the meaning of the operative definition, however, the manager of a private investment fund is squarely an investment adviser: it is engaged in the business of advising others (the fund and, derivatively, the fund’s investors) for compensation as to investments in securities.

## ***2. When Registration Is Required***

Once a person is an investment adviser within the meaning of § 202(a)(11), the next question is whether registration is required and, if so, where. Dodd-Frank reallocated regulatory jurisdiction between the SEC and the States by amending § 203A. The current framework distinguishes three categories based on regulatory assets under management (“RAUM”), with several special categories overlaid:

- **“Small advisers” with RAUM below \$25 million.** State-registered; SEC registration generally prohibited.
- **“Mid-sized advisers” with RAUM between \$25 million and \$100 million.** Generally State-registered in the State of their principal office and place of business, unless the adviser is either (i) not subject to examination by that State (rare; New York and Wyoming) or (ii) required to register in 15 or more States.
- **Large advisers with RAUM of \$100 million or more.** SEC-registered.
- **Advisers solely to private funds with RAUM of \$150 million or more.** SEC-registered regardless of the State allocation rules. (Below the \$150 million threshold, such advisers are exempt reporting advisers under § 203(m); see Subpart IX.E.3 below.)
- **Advisers to registered investment companies.** Always SEC-registered.
- **Non-U.S. advisers.** Subject to SEC jurisdiction to the extent of their U.S. activities; the foreign private adviser exemption (Subpart IX.E.3) is narrowly available.

## ***3. Exempt Reporting Advisers and Other Exemptions***

Even where an adviser meets the threshold for SEC registration, three categorical exemptions added by Dodd-Frank are of central importance for fund managers. The first two — the private fund adviser exemption and the venture capital fund adviser exemption — exempt the adviser from

registration but require it to file an abbreviated public report on Form ADV. Advisers relying on these exemptions are known as “exempt reporting advisers” (ERAs). The third — the foreign private adviser exemption — is a complete exemption from both registration and reporting but is narrowly drawn and rarely available to substantial non-U.S. fund managers.

**Private fund adviser exemption (§ 203(m); Rule 203(m)-1).** Exempts any adviser that acts solely as an adviser to qualifying private funds (3(c)(1) or 3(c)(7) funds) and that has aggregate RAUM attributable to private funds in the United States of less than \$150 million. The exemption is lost if the adviser takes on any non-private-fund client (e.g., a separately managed account for a single investor) or if RAUM exceeds the threshold.

**Venture capital fund adviser exemption (§ 203(l); Rule 203(l)-1).** Exempts any adviser that acts solely as an adviser to one or more “venture capital funds” within the meaning of Rule 203(l)-1. A “venture capital fund” must, in summary, (i) represent itself as pursuing a venture capital strategy; (ii) hold no more than 20% of its capital in non-qualifying investments (largely limited to direct equity investments in qualifying portfolio companies); (iii) not borrow more than 15% of its capital and only on a short-term basis; (iv) not offer redemption rights to investors except in extraordinary circumstances; and (v) not be registered under the 1940 Act or a BDC. No RAUM cap applies.

**Foreign private adviser exemption (§ 202(a)(30)).** Exempts a non-U.S. adviser that (i) has no place of business in the United States; (ii) has fewer than 15 U.S. clients and U.S. investors in private funds combined; (iii) has aggregate U.S. AUM of less than \$25 million; and (iv) does not hold itself out to the U.S. public as an investment adviser. The 15-client/investor cap and the \$25 million AUM cap make the exemption unavailable to most non-U.S. managers with meaningful U.S. business.

ERAs (those relying on the private fund adviser or venture capital fund adviser exemptions) are required to file public Form ADV Parts 1A and a limited subset of items, to update those filings annually and upon material changes, and to comply with certain books-and-records and anti-fraud provisions of the Advisers Act — including § 206 — but are not subject to the full compliance regime applicable to registered advisers. The operational and cost differential between ERA status and full registration is substantial; many emerging managers structure their RAUM and client base specifically to remain within the ERA exemptions.

**Table IX.E-1 – Investment Adviser Registration Status by Adviser Type**

<b>Adviser Category</b>	<b>Threshold / Criteria</b>	<b>Registration Status</b>	<b>Filing &amp; Compliance Obligations</b>
Small Adviser	RAUM < \$25M.	State-registered; SEC registration prohibited.	State Form ADV; State compliance rules apply.
Mid-Sized Adviser	RAUM \$25M – \$100M (and either subject to State exam or filing in <15 States).	State-registered.	State Form ADV; State compliance rules apply.
Large Adviser	RAUM ≥ \$100M.	SEC-registered.	Full Form ADV (Parts 1, 2A, 2B); full Advisers Act compliance regime; SEC examination.
Private Fund Adviser Exempt (§ 203(m))	Adviser solely to qualifying private funds; U.S. RAUM < \$150M.	Exempt reporting adviser (ERA); SEC registration not required but abbreviated Form ADV filed.	Form ADV Part 1A (subset of items); annual updates; books and records; § 206 anti-fraud; political-contributions rule; reduced examination exposure.
VC Fund Adviser Exempt (§ 203(l))	Adviser solely to one or more “venture capital funds” under Rule 203(l)-1; no RAUM cap.	ERA.	Same as private fund adviser ERAs.
Foreign Private Adviser (§ 202(a)(30))	No U.S. place of business; <15 U.S. clients/investors; U.S. RAUM < \$25M; no holding out.	Fully exempt; no Form ADV.	Anti-fraud only.
Private Fund Adviser ≥ \$150M	Adviser to private funds with RAUM ≥ \$150M.	SEC-registered (regardless of State rules).	Full registered adviser compliance regime.
RIC Adviser	Adviser to one or more registered investment companies.	SEC-registered.	Full registered adviser compliance regime plus 1940 Act § 15 contract requirements.
Family Office	Satisfies Rule 202(a)(11)(G)-1 (single-family clients; family ownership and control; no holding out).	Excluded from the definition; no registration or reporting.	None under the Advisers Act.

#### 4. Substantive Conduct Rules

A registered investment adviser is subject to a comprehensive set of substantive conduct rules. Section 206 of the Advisers Act imposes the foundational anti-fraud provisions, which apply to both registered and unregistered advisers (including ERAs) and impose a fiduciary duty on the adviser-client relationship. The Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), held that § 206 imposes “an affirmative obligation of utmost good faith, and full and fair disclosure of all material facts” and that the adviser is a fiduciary to its clients — a foundational doctrinal principle subsequently elaborated in numerous SEC enforcement actions and in the 2019 Commission Interpretation Regarding Standard of Conduct for Investment Advisers (Release No. IA-5248).

Beyond § 206, the principal conduct rules applicable to registered advisers include the following:

- **Custody rule (Rule 206(4)-2).** Detailed safekeeping requirements applicable to advisers that have “custody” of client assets, including the use of qualified custodians, delivery of account statements, and (for many private fund advisers) the annual independent audit and distribution of audited financial statements within 120 days of fiscal year-end. The custody rule is the source of much of the operational compliance burden of fund management.
- **Marketing rule (Rule 206(4)-1, revised effective November 2022).** Governs the use of testimonials, endorsements, third-party ratings, and performance presentations, including the requirements applicable to hypothetical performance, related performance, and net-of-fees presentation.
- **Compliance rule (Rule 206(4)-7).** Requires written compliance policies and procedures reasonably designed to prevent violation of the Advisers Act, designation of a chief compliance officer, and annual review of the compliance program.
- **Code of ethics rule (Rule 204A-1).** Requires adoption of a code of ethics addressing personal securities trading by access persons, holdings and transactions reports, and pre-clearance of certain investments.
- **Pay-to-play rule (Rule 206(4)-5).** Restricts the ability of an adviser to provide advisory services for compensation to government clients within two years after a political contribution by the adviser or its covered associates to certain elected officials.
- **Form ADV delivery (Rule 204-3).** Requires delivery of Form ADV Part 2A (the brochure) to each client at the inception of the advisory relationship and annual delivery thereafter (or summary updates with offer to deliver).
- **Recordkeeping rule (Rule 204-2).** Specifies the books and records required to be maintained for prescribed periods (generally five years, with the first two on-site).
- **Proxy voting rule (Rule 206(4)-6).** Requires written policies and procedures for the voting of client securities and disclosure of the policies and of voting records.

In February 2024, the SEC adopted the so-called “Private Fund Adviser Rule” (Rule 211(h)-1 and related provisions), imposing significant new obligations on private fund advisers including quarterly statements, annual audits, prohibited activities provisions, and preferential-treatment disclosure requirements. The Fifth Circuit, in *National Association of Private Fund Managers v. SEC*, 103 F.4th 1097 (5th Cir. 2024), vacated the Private Fund Adviser Rule in its entirety, holding that the SEC had exceeded its statutory authority. The Commission did not seek Supreme Court review, and as of the date of this memorandum the Rule is not in effect. The episode illustrates both the SEC’s continuing regulatory ambitions in the private fund space and the increasingly active role of the federal courts in policing the boundaries of administrative authority following *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024) (overruling *Chevron* deference).

#### **F. Section 12(g) and Securities Exchange Act of 1934 Reporting**

Section 12(g) of the Securities Exchange Act of 1934 imposes registration and reporting obligations on issuers whose securities are widely held, even where those securities are not listed on a national securities exchange. The threshold for § 12(g) registration is, since the JOBS Act of 2012, that the issuer have total assets exceeding \$10 million and a class of equity securities held of record by either (i) 2,000 or more persons or (ii) 500 or more persons who are not accredited investors. Once an issuer is subject to § 12(g) registration, it must file annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and proxy statements under § 14, and is subject to the insider-reporting and short-swing-profit provisions of § 16.

For private investment funds, the relevance of § 12(g) is principally negative: the fund must avoid inadvertently exceeding the holder-of-record thresholds, which would trigger reporting obligations utterly inconsistent with private-fund operation. In practice, this constraint operates in tandem with the 1940 Act § 3(c)(1) 100-person limit (which is more restrictive in any event for funds relying on that exclusion) and with the 1940 Act § 3(c)(7) qualified-purchaser eligibility limit. For § 3(c)(7) funds, however, the § 12(g) holder-of-record threshold of 2,000 holders of record (or 500 non-accredited holders of record) can become a binding constraint on investor count growth, and modern fund LPAs include provisions designed to monitor and manage holder-of-record counts (including transfer restrictions and rights of first refusal designed to prevent the inadvertent creation of additional holders of record).

## **G. State Blue-Sky Laws and NSMIA Preemption**

The State “blue-sky” laws — so named because, in the colorful contemporaneous formulation, they were directed at promoters who would sell investors “the blue sky itself” — predate the federal securities regime and continue to operate alongside it. Each State has enacted a securities statute that imposes registration requirements on the offer and sale of securities within the State, anti-fraud provisions, and provisions governing the registration of broker-dealers and investment advisers. The constitutional foundation for State securities regulation was confirmed by the Supreme Court in *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917), which sustained Ohio’s blue-sky law against a Commerce Clause challenge.

The National Securities Markets Improvement Act of 1996 (“NSMIA”) substantially preempted State registration and merit-review authority over a defined category of “covered securities” under § 18 of the Securities Act. Securities issued in transactions exempt under Rule 506 of Regulation D are covered securities, with the consequence that State registration and merit-review requirements are preempted (although the States retain authority to require notice filings, to collect fees, and to apply their anti-fraud provisions). For private investment funds relying on Rule 506(b) or Rule 506(c), the State-law overlay reduces in practice to a notice filing in each State of investor residence, accompanied by the prescribed fee, and ongoing applicability of State anti-fraud provisions.

Two State-law areas remain meaningful notwithstanding NSMIA. First, State investment-adviser registration is imposed by each State on advisers with sufficient nexus to the State that do not qualify for SEC registration (and is not preempted by NSMIA for ERAs to the extent the State requires ERA filings, which most States do). Second, State broker-dealer registration applies to persons engaged in the business of effecting transactions in securities, including (potentially) persons soliciting investors for fund interests. Both areas are sources of significant compliance attention in fund-formation practice, although they do not generally affect entity selection.

## X. SUMMARY COMPARISON

The principal distinctions developed in the preceding Parts may be summarized in tabular form. Subpart X.A compares the four entity types from the standpoint of business-entity law, federal income taxation, and securities regulation. Subpart X.B compares the four federal tax sub-regimes themselves. The tables distill the foregoing analysis to its essential elements; the body of the memorandum supplies the doctrinal grounding for each entry.

### A. Comparison of the Four Entity Types

Feature	Corporation	General Partnership	Limited Partnership	Limited Liability Company
<b>Formation</b>	State filing required (Cert. of Incorp.)	No filing; arises by operation of law	State filing required (Cert. of LP)	State filing required (Cert. of Formation/Org.)
<b>Liability of owners</b>	Limited (subject to veil-piercing)	Unlimited personal liability for all partners	GP unlimited; LPs limited to capital contribution	Limited for all members
<b>Default management</b>	Centralized in board of directors	Decentralized; each partner is agent	Centralized in GP; LPs passive	Member-managed or manager-managed (elective)
<b>Continuity of life</b>	Perpetual	Fragile (UPA); contractual under RUPA	Perpetual subject to LPA	Perpetual subject to OA
<b>Single owner permitted</b>	Yes	No ( $\geq 2$ partners required)	No ( $\geq 1$ GP + $\geq 1$ LP)	Yes (single-member LLC)
<b>Default federal tax</b>	Subchapter C (double tax)	Subchapter K (pass-through)	Subchapter K (pass-through)	SMLLC: disregarded; multi-member: Subchapter K
<b>Special allocations § 704(b)</b>	Not available	Available	Available (most flexible context)	Available
<b>SECA on owner income</b>	No (corporate; W-2 wages possible)	Yes — full distributive share	GP yes; LP exception § 1402(a)(13) (narrowed by Soroban)	Uncertain; active members likely subject
<b>NY publication required</b>	No	No	Yes (N.Y. P'ship Law § 121-201(c))	Yes (N.Y. LLCL § 206)

Feature	Corporation	General Partnership	Limited Partnership	Limited Liability Company
<b>Suitability as primary fund vehicle</b>	No (except RIC/REIT/BDC under Subch. M)	No (universal personal liability)	Yes — dominant form	Possible but disfavored vs. LP
<b>Suitability as GP / mgmt company</b>	Possible (S-corp for SECA; C-corp for blockers)	No (universal liability)	No (rigid GP/LP split unsuited)	Yes — dominant form
<b>Suitability as SPV</b>	Rare	No	Rare	Yes — dominant form (frequently SMLLC)
<b>Suitability for IPO / public markets</b>	Yes — required form	No	Limited (MLPs only, narrow rules)	Limited (Up-C structures)
<b>CTA reporting</b>	Generally required	Generally outside (no filing)	Generally required	Generally required

**B. Comparison of the Four Federal Tax Sub-Regimes**

Feature	Subchapter C	Subchapter S	Subchapter K	Subchapter M (RIC/REIT)
<b>Conduit mechanism</b>	None — entity-level tax retained	Pass-through by attribution to shareholders	Entity is non-taxpayer; items flow through	Dividends-paid deduction (corporate form preserved)
<b>Entity-level tax</b>	21% under § 11	None (except § 1374 BIG, § 1375 PII)	None	Effectively zero if 90% (RIC/REIT) distributed
<b>Owner-level tax</b>	On dividends (qualified rate); deferred	On distributive share (annual); regardless of distribution	On distributive share (annual); regardless of distribution	On dividends (1099-DIV); current
<b>Loss flow-through</b>	No (losses trapped at entity)	Yes (subject to basis, at-risk, passive)	Yes (subject to basis, at-risk, passive)	No (losses trapped at entity; carried forward)
<b>Special / non-pro-rata allocations</b>	Not available	Generally not (single class of stock)	Available under § 704(b)	Not available (pro-rata to shares)
<b>Number of owners admissible</b>	Unlimited	Max 100 shareholders	Unlimited (subject to securities-law)	Unlimited (RIC); ≥ 100 holders

Feature	Subchapter C	Subchapter S	Subchapter K	Subchapter M (RIC/REIT)
			constraints)	required for REIT
<b>Owner eligibility restrictions</b>	None	U.S. individuals, certain trusts/estates only	None	None as such (but RIC requires 1940 Act registration)
<b>Character flow-through</b>	No (all distributions are dividends or return of capital)	Yes — generally fully preserved	Yes — most fully preserved	Partial — capital gain dividends, exempt-interest dividends, QDI
<b>Owner reporting</b>	Form 1099-DIV (simple)	Schedule K-1	Schedule K-1 (most complex)	Form 1099-DIV (simple)
<b>Compatibility w/ retail distribution</b>	Yes (operational; double tax cost)	No (100-shareholder limit)	No (Schedule K-1 burden)	Yes — designed for retail
<b>Principal use</b>	Operating C-corps; blockers; public RICs/REITs	Closely-held businesses; mgmt companies	Private funds; LLCs and LPs generally	Mutual funds, ETFs, closed-end funds, BDCs, REITs

## XI. CONCLUSIONS

The principal conclusions of this memorandum may be stated as follows. First, no single entity form is optimal for all investment-vehicle purposes. The four available forms — corporation, general partnership, limited partnership, and limited liability company — differ along multiple axes (liability exposure, formation formality, internal governance, fiduciary modification, continuity, transferability, single-owner permissibility, federal tax treatment, securities-law treatment), and the optimal choice for a given role depends on which axes are most relevant to that role.

The general partnership has, with rare exceptions, become functionally obsolete in modern practice because of its imposition of universal personal liability; it remains the residual category into which inadvertent partnerships fall, and the doctrinal framework against which other forms are defined, but it is rarely chosen affirmatively.

Second, in private investment fund practice, the limited partnership has emerged as the dominant primary fund vehicle for an interlocking set of structural, regulatory, tax, contractual, and institutional reasons.

The LP's rigid GP/LP wall maps onto the economic relationship between manager and investors with unusual precision; its statutory architecture supplies clean treatment under ERISA, the 1940 Act, the Volcker Rule, and other regulatory frameworks; the depth of Delaware fiduciary-duty jurisprudence supplies predictability; the standardization of LPA terms by ILPA and institutional investors supplies negotiating efficiency; and the LP's operational rigidity is, in this context, a feature rather than a defect.

The classical objection to the LP form — the unlimited liability of the general partner — is neutralized by the simple expedient of inserting an LLC between the natural-person sponsor and the fund, and the resulting three-tier (or four-tier) architecture has become the institutional default.

Third, the corporation, although disfavored as a primary fund vehicle, retains primacy in several specific roles. Subchapter M permits corporate-form vehicles (mutual funds, ETFs, closed-end funds, BDCs, and REITs) to obtain conduit treatment without the partnership's administrative impossibility, and the corporate form is, for retail-distributed pooled investments, structurally inescapable.

C-corporation "blockers" interposed in fund structures convert UBTI- or ECI-bearing partnership allocations into UBTI- and ECI-free portfolio dividends, exploiting the double tax of Subchapter C as a structural feature rather than a defect.

Operating-business portfolio investments destined for public offerings are organized as corporations to support fungible equity, tax-free reorganizations under § 368, and stock-option compensation. The S corporation finds limited application as the management company of a service-providing business where SECA optimization is the dominant concern.

Fourth, the limited liability company occupies the institutional middle ground. It is rarely the primary fund vehicle and rarely the public-markets operating company, but it is the universal choice for a long list of supporting and ancillary entities — the GP of the fund, the management company, the sponsor or parent holdco, special-purpose vehicles for individual portfolio investments, co-investment vehicles, aggregator vehicles, and the holding entities sitting above blocker corporations.

The LLC's combination of universal liability shield, governance flexibility, pass-through tax treatment under Subchapter K (or disregarded-entity treatment for SMLLCs), and the absence of formal governance constraints makes it the best-calibrated form for those supporting roles.

Fifth, beyond entity selection, hedge funds and other actively-trading investment vehicles face a layered set of trading-activity tax rules — the wash-sale rule of § 1091, the straddle rules of § 1092, the § 1256 mark-to-market regime for regulated futures and similar contracts, the constructive-sale rules of § 1259, the elective § 475(f) mark-to-market regime, the disguised-payment-for-services rules of § 707(a)(2)(A) as amended by OBBBA, and the State-level PTET regimes that have proliferated since 2017.

These rules collectively define a planning topology that requires routine attention and that, in important respects, is more consequential to fund operating economics than entity selection itself.

Sixth, the practical implication for any investment-vehicle design exercise is that entity selection is not a single decision but a matrix of decisions — one for each role in the structure. The fund itself, the GP, the management company, the sponsor holdco, the blockers, the SPVs, the carry vehicles, and the offshore entities each present distinct legal, tax, regulatory, and commercial problems, and each is optimally addressed by a different form.

The architecture of an institutional-quality fund structure is thus, by design, a multi-entity optimization, in which each component's comparative advantage is matched to the problem it solves.

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