- Conflicts of interest
- Standard of conduct
- Disciplinary history of the firm and its professionals
- An explanation of how a customer can obtain additional information on the firm
- Broker-dealers must deliver a Form CRS to each retail investor, before or at the earliest of: (1) a recommendation of an account type, a securities transaction, or an investment strategy involving securities; (2) placing an order for the retail investor; or (3) the opening of a brokerage account for the retail investor.

Broker-dealers are required to file Form CRS with FINRA through the Central Registration Depository ("Web CRD"). Any changes to Form CRS must be communicated to existing customers within 60 days of the amendments. A current Form CRS must be provided to any customer upon request, as well as posted prominently on the broker-dealer's website.

Note: The requirement to provide a relationship summary on Form CRS is not the same thing as Regulation Best Interest's disclosure obligation. The disclosure obligation typically requires more information than is provided by Form CRS.

2.5. INVESTORS

There are many different categories of investors. Some types of investors tend to focus on specific types of investments; others have their fingers in many different pies, figuratively speaking. Having an understanding of the universe of investor types, and of which types of investors are most interested in specific investment types, is valuable—and testable—knowledge.

There is some overlap between the following categories; a qualified institutional buyer, for example, will also meet the criteria to be an institutional investor, and an individual investor may or may not be an accredited investor.

A concept from the SIE worth recalling as you read this section, as well as the following one on organizational structures, is that of a fiduciary duty. A **fiduciary duty** is a legal duty to place another party's interests ahead of one's own. Many of the types of investors and organizational structures described below involve fiduciary duties in one way or another. For example, a retail investor is owed a fiduciary duty by his investment adviser, and a corporation's shareholders are owed a fiduciary duty by the corporation's board of directors. If a FINRA member firm obtains information about the ownership of securities while acting in a fiduciary capacity, it may not use this information to solicit transactions in the security other than at the request and on behalf of the issuer.

FINRA Rule 2060

Individual. Individual investors are basically another name for **retail investors**. As opposed to individuals who manage the portfolios of others, individual investors invest on their own behalf. There are many more individual investors in the world than there are institutional investors: every employee with a 401(k), every grandma with a savings bond, and every CNBC viewer, *Money* reader, and Motley Fool browser who dabbles with stock picks swells their ranks.

Most individual investors invest in securities through conduits such as mutual funds or ETFs. Retail investors who do invest directly traditionally did so through full-service retail brokerages, although discount online brokerages have become much more popular in recent years. While the aggregate amount of retail investment in the financial markets is very large, it does not approach the total dollar value of institutional investment.

Many large investment banks are affiliated with retail brokerages that deal directly with individual investors. That said, investment bankers will typically deal directly only with the relatively small universe of individual investors with very high net worth, or at a minimum "accredited investors" (covered later in this chapter), simply because such investors are the only ones with sufficient resources to invest in the sorts of transactions investment bankers work on.

There is no official definition of a **high net worth individual (HNWI)**, but the term is often used to describe individuals with liquid assets of more than $1 million. **Very high net worth individuals (VHNWIs)** generally have liquid assets of $5 million to $50 million, while **ultra high net worth individuals (UHNWIs)** have liquid assets that exceed $50 million. You can guess which group is most sought after by money managers.

A subcategory of individual investor to be aware of is the **corporate insider**. Insiders are members of corporate management, directors, and significant shareholders. The interests of insiders may need to be accommodated in a public offering or in other contexts where insiders need to "cash out" their investment in a company.

Institutional. "Institutional investor" is really a catch-all term that encompasses an array of organizations that have pooled capital to invest. Institutional investors are responsible for a majority of the trades in most financial markets. Collectively, these organizations command vast sums of capital, making them the big kahunas of the investor world. Because of their clout as shareholders, they often wield significant influence over corporate governance and policy.

Institutional investors include banks, insurance companies, and registered investment companies. An investment adviser registered with the SEC or a state securities commission is also considered an institutional investor, as is any person or entity with $50 million or more in total assets.

A debt or equity transaction of any significant size will almost always involve institutional investors. Institutional investors make up the primary market for bond issues, initial public offerings (IPOs), and private placements, and institutional receptivity to a proposed transaction can often make or break its viability.

There are many different types of institutional investors, and certain types favor specific categories of investments.

Accredited. Certain securities transactions are subject to lighter regulation if some or all of the buyers are accredited investors, which are defined as any of the following:

- Banks, broker-dealers, investment advisers, insurance companies, and investment companies

- Corporations, trusts, partnerships, and LLCs with more than $5 million in assets
- Most employee benefit plans with more than $5 million in assets
- The issuer's directors, executive officers, and general partners
- If the issuer is a privately owned fund such as a hedge fund, a knowledgeable employee of the fund, which means an employee with at least 12 months' experience working on the fund's investment activities
- Individuals with income of $200,000 in each of the last two years, or $300,000 in combination with a spouse or spousal equivalent such as a domestic partner
- Individuals with a net worth more than $1 million, alone or with a spouse or spousal equivalent, not including primary residence
- Individuals with a current Series 7, 65, or 82 license
- Any firm where all owners are accredited investors (e.g., venture capital firms)
- Any other entity with more than $5 million in investments that was not formed specifically to qualify as an accredited investor; the purpose of this category is to include entities that don't neatly fit into any of the above categories, such as:
    - Native American tribes
    - Labor unions
    - Government bodies, including those of foreign governments
    - Investment funds created by government bodies
    - New types of business entities that may be introduced by new laws

An accredited investor that is not an individual—such as a business, governmental, or nonprofit entity—is sometimes called an **institutional accredited investor (IAI)**.

Qualified purchaser. By law, certain hedge funds and other private investment funds may only accept investments from qualified purchasers. This is a stricter standard than the "accredited investor" standard. Anyone who meets the definition of a qualified purchaser will also meet the definition of an accredited investor. Qualified purchasers include:

- Individuals, family-owned organizations, or trusts with investments of $5 million or more
- A company with $25 million or more in investments
- An investment manager with $25 million or more under management
- A company beneficially owned exclusively by qualified purchasers
- Most qualified institutional buyers (see below)

Mutual fund. Mutual funds are professionally managed funds, operated by an investment company, that pool together capital from many investors and invest it on their behalf. The investment company charges a fee for this service. Mutual fund shares are redeemable on demand.

Most mutual funds concentrate on stock, but they may also invest in debt, derivatives, currencies, precious metals, or other types of assets or financial instruments. In terms of investment objectives, there is no "typical" mutual fund. For example, some mutual funds seek the highest returns, while others seek to preserve capital and minimize risk; some invest only in large-cap equities, while others focus on small-caps; some invest primarily in U.S. equities, while others have an international focus; and some concentrate on industry sectors.

Mutual funds with a similar focus are often grouped into categories. For example, a **growth fund** is a mutual fund that invests in growth stocks (or tries to), while an **index fund** strives to create a portfolio that matches the component stocks of a specific market index. A **money market fund** invests in short-term, highly liquid securities, such as government securities, certificates of deposit, and commercial paper.

Hedge fund. A **hedge fund** is a fund that tries to achieve a positive return for its investors, even when market returns are negative. Hedge funds are similar to mutual funds in that they pool investors' money and invest it in securities, but they usually try to avoid classification as a mutual fund so that they are not subject to the restrictions placed on mutual funds. Hedge funds avoid being called mutual funds by meeting one of two exemptions:

- They limit the number of investors to 100. Up to 35 of these may be non-accredited; the rest must be accredited.
- They sell to only qualified purchasers.

Hedge funds also differ from mutual funds in that they usually rely on broader investment strategies, such as investing in derivatives to hedge risk and increase leverage. (**Leverage** in this context means the use of debt to finance an investment. The word can also refer to the amount of debt that a company takes on for this purpose. The use of leverage is typically thought to increase risk, because the investor still owes the debt if the investment fails.) Hedge funds often invest in more long-term, less-liquid investments than mutual funds. For all these reasons, hedge funds tend to be riskier than other investment vehicles and, thus, may face high returns and high losses. Because of their increased risk and illiquid nature, hedge funds are usually available to accredited investors only.

Unlike most mutual funds that can be redeemed at any time, hedge funds often have limited periods when they can be redeemed (monthly, quarterly, or annually). Additionally, hedge funds are usually subject to lock-up periods: investors cannot redeem their shares in the first one or more years of investment. For these reasons, hedge funds are suitable for only those investors who can lock up their money for a long period.

Hedge funds set high minimum investment amounts for their investors. High risk coupled with high-minimum investments make hedge funds a tool for wealthy individuals and institutions seeking high returns. Typical investors tend to be insurance companies and pension funds.

Investors in a hedge fund generally pay a management fee of 2% of their invested assets annually, plus 20% of the profit. Because of the high management fees and risk, a representative must make sure the fund is suitable for the investor. The investor must be known to be risk tolerant and be advised of the investment risks.

SAMPLE QUESTION

A particular hedge fund will receive 2% annually and 20% of any profits. This year an investor makes $1 million in returns on a $10,000,000 investment. How much money will the hedge fund receive from the investor?

A. \$220,000
B. \$200,000
C. \$350,000
D. \$400,000

Answer: D. The management fee will be \$200,000 (10 million x 0.02). The hedge fund would share in 20% of the profits. The investor made \$1 million in profits, so 20% would be \$200,000. In total, the investor will have to pay \$400,000, \$200,000 for the management fee and a \$200,000 percentage of the profits.

Hedge funds are subject to the same anti-fraud rules as other types of investments in the securities industry, and fund managers owe a fiduciary duty to the fund. After the financial crisis of 2008, in which hedge funds played a significant part, the **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010** (or **Dodd-Frank** for short) required funds with over \$150 million in assets to register with the SEC.

Dodd-Frank also created a Financial Stability Oversight Council to track hedge funds for the size of their investments. Funds that it considers "too big to fail" (that is, they must not be allowed to fail to avoid harming the economy) may be subject to regulatory oversight by the Federal Reserve. Finally, investment banks can now use hedge funds only on behalf of their customers and not to generate their own corporate profits.

Private equity (PE) fund. PE funds generally seek to acquire large or majority ownership stakes in private companies or public companies that the PE fund plans to take private. Like hedge funds, private equity funds pool the capital of deep-pocketed investors to accomplish their aims. Investors in private equity funds are institutional or very wealthy individuals. Also like hedge funds, private equity funds can limit the ability of investors to withdraw or transfer their interests, so ownership interests are usually not very liquid. Unlike hedge funds, however, private equity usually employs significant debt financing. This use of leverage means private equity returns can be very high. The investment strategy is often to cut costs, improve operations, and resell the assets when markets are buoyant and demand for corporate assets is strong.

Different private equity firms have different goals. Some funds act as **venture capitalists**: they invest in early-stage or relatively unknown companies that have significant growth potential, usually with the ultimate goal of cashing out when a company is acquired or goes public. Other private equity funds focus on acquiring companies. Some funds take over distressed companies and turn them around, while others focus on leveraged buyouts of public companies or portions of public companies (which then go private).

Endowment. An endowment is the permanent fund of a specific institution, such as a university or philanthropic foundation. Endowments are often sophisticated investors that may invest not only in traditional securities but also via hedge funds, private equity funds, and REITs.

Insurance company. Insurance companies are collectively among the most important, if not the most important, institutional investors. Insurance companies invest the premiums they receive—and given the volume of insurance premiums paid each year, this fact translates to a huge presence in the financial markets. Most insurers in the United States are regulated by state agencies, which normally require insurance company investments to be relatively low-risk. Insurance companies are significant purchasers of investment grade corporate bonds.

Pension fund. Like insurance companies, pension funds invest enormous sums of money in the financial markets. A pension fund may be set up by an individual employer, a trade union or business association, a nonprofit, or a government entity; the latter category includes some of the biggest and most influential investors around. For example, in 2013, the California Public Employees Retirement System (CalPERS) managed a fund worth more than $250 billion.

In many cases, pension funds are subject to restrictions in the types of investments they can make. This is especially true of governmental or quasi-governmental pension funds, which are usually limited by statute to an approved list of investments.

Qualified institutional buyer (QIB or QUIB). A QIB, also sometimes called a QUIB, is a large institutional investor that owns at least $100 million worth of securities, not counting securities issued by its affiliates. For registered broker-dealers, the threshold is only $10 million. A bank must also have a net worth of at least $25 million in order to be considered a QIB.

Common examples of QIBs include broker-dealers, insurance companies, investment companies, pension plan, and banks. However, any corporation, partnership, or LLC could qualify as a QIB. So can an IAI that owns at least $100 million in securities. Individuals can never be QIBs, regardless of their assets or financial sophistication.

If a firm has discretionary authority to invest securities owned by a QIB, those securities count toward whether the firm itself is considered a QIB.

Example: ABC Broker-Dealer owns $9 million of securities in its own accounts. It controls $1 million of securities in a discretionary account for DEF Pension Fund. If DEF is a QIB, then its $1 million counts toward whether ABC is considered a QIB.

Government entity. Governments are not always thought of as part of the investor community, but the sheer size of the government sector guarantees that governments sometimes act as investors in the financial markets. Apart from the federal bailouts of auto companies and financial institutions in 2008 and 2009, in the course of which Uncle Sam acquired a significant ownership interest in some large corporations, the government often buys debt—especially Treasuries, but also including commercial paper and other private obligations. Government entities frequently guarantee obligations and act as significant market participants indirectly; for example, via pension plans and the purchase and sale of agency obligations. Governments may invest in public-private partnerships (in the defense context, for example) and may offer tax breaks to private companies that build plants or otherwise invest within their jurisdictions. Government agencies may sometimes invest in derivatives; for example, a transit agency may buy a contract to hedge its fuel costs.

Foreign governments are apt to have a much more active role in directly investing in private companies. Foreign governments may also invest in the financial markets directly, often in the form of so-called sovereign wealth funds. Foreign governments are important purchasers of U.S. Treasury securities.

Employee stock ownership plan (ESOP). An ESOP is an employee benefit plan that invests exclusively in the stock of the employer. Employees may become shareholders through purchase, profit sharing, or stock options, but in most cases shares are given to employees. ESOPs can offer tax benefits to the sponsoring employer and are sometimes used for corporate finance purposes. ESOPs also can provide a market for shares of a retiring owner of a closely held company. ESOPs may be active investors, but their activity is generally limited to a single stock.

As an aside, establishing an ESOP is a tactic that is sometimes used to thwart a hostile takeover attempt. Depending on the state, an ESOP controlling as little as 15% of the outstanding stock is all that is needed to halt a takeover bid. Moreover, an ESOP plan may include a provision requiring any buyer in an acquisition to purchase ESOP shares at the greater of market value or a specified minimum price. If the specified price is substantially higher than the market price, the extra cost may dampen the ardor of the would-be buyer.

SUMMARY

CHARACTERISTICS OF HEDGE FUNDS

- Differ from mutual funds in that they usually rely on broader investment strategies, such as short selling and investing in derivatives to hedge risk, speculate, and increase leverage
- Often invest in long-term, illiquid investments
- Riskier than other investment vehicles, such as mutual funds, and may face high returns and high losses
- Because of higher risk and illiquid nature, are mainly used by institutions and wealthy individuals
- Shares often have limited periods when they can be redeemed (monthly, quarterly, or annually), unlike mutual fund shares, which can be redeemed at any time
- Often organized as limited partnerships
- Provide information to investors in private offering memorandum or private placement memorandum
- Usually subject to lock-up periods, meaning that investors usually cannot redeem shares in the first one or more years of investment
- Though exempt from registration, subject to anti-fraud provisions of securities laws

2.6. ORGANIZATIONAL STRUCTURES

The traditional and simplest forms of business organizations are the sole proprietorship (for individuals) and the partnership (for more than one person). While these structures are not without benefits in the right situation, they present disadvantages: they do not shield their owners from unlimited liability, they do not survive their owners, and they are generally unsuited to complex business endeavors.

To address these shortcomings, many organizational structures have evolved over the years. In the United States, most entity types are created under state law, while others are creatures of the federal tax code. Which structure best suits a particular purpose is a matter of judgment and an analysis of the business's current and expected future circumstances; there is no "perfect" business entity for all situations.

In analyzing organizational structures, bear in mind that one type of business entity can be part of another business entity; for example, a C corporation can have a subsidiary that is structured as a limited liability company, and can also be part of a limited partnership.

The following list of entity types excludes certain uncommon business structures, as well as structures that are limited to specific types of businesses, such as national banks, professional corporations, and limited liability partnerships.

C corporation (C corp). A C corporation is what most people think of simply as a corporation. (The "C" in the name refers to the subchapter of the Internal Revenue Code that deals with corporate taxation.) The corporate form is by far the most prevalent organizational structure for large and medium-sized businesses, especially publicly held businesses, and for many small businesses as well.

In the United States, a corporation is created by **incorporating** (filing articles of incorporation) in the state of its choice. The state of incorporation is typically either the state where the corporation's headquarters are located or a state such as Delaware with a well-developed body of corporate law. Once created, the corporation can operate anywhere, subject to compliance with federal law and the laws of individual states and other jurisdictions.

When a corporation is created, it issues shares of stock. The corporation is owned by its shareholders. The shareholders can be individuals, investment funds, other business entities, or even governments. To run the corporation, shareholders elect a board of directors, which oversees the corporation and appoints management to deal with its day-to-day operations.

The corporate form offers several important benefits:

- Shareholders have **limited liability** for corporate debts. While a shareholder could lose her entire investment in a corporation if the corporation fails, shareholders are usually not personally liable for the corporation's debts.
- The length of time a corporation can exist is not limited. A corporation may have a perpetual existence. (Of course, corporations fail all the time, but that's not a result of legal limits on the term of their existence.)
- Corporations have many of the same rights as persons. They can sue or be sued, hire employees, enter into contracts, and incur debt.
- The shares of a corporation are usually freely transferable.

Corporations are taxed on their profits at the entity level. If the corporation pays dividends, the dividends are then taxable to shareholders. For this reason, C corps are often said to be subject to **double taxation**.

S corporation (S corp). An S corporation is not, strictly speaking, an entity type. Rather, an S corp is a corporation that has filed a notice with the IRS electing to be taxed under Subchapter S of the Internal Revenue Code. This election subjects an S corporation to **pass-through taxation**. Pass-through tax status means that S corporations are not subject to entity-level tax, and therefore they avoid double taxation. An entity that enjoys this benefit is called a **pass-through entity**. Sole proprietorships and partnerships are also pass-through entities.

S corporations are taxed like partnerships: the corporation passes all income, losses, deductions, and credits on to its shareholders, who pay tax on their share of the corporation's profits at their individual income tax rates. Note that an S corporation does not always offer a tax advantage to shareholders, because dividends paid by C corporations are taxed at a special rate, and that rate is often lower than an individual's marginal income tax rate.

S corporations that employ shareholders must pay the shareholders "reasonable compensation," which the IRS typically views as meaning the prevailing local wage for the work performed. This requirement is imposed to prevent shareholders from receiving compensation in the form of dividends, which are not subject to payroll taxes, instead of as wages, which *are* subject to payroll taxes.

An S corporation must also meet all the following requirements:

- It must be a domestic corporation. Foreign corporations are not eligible to make a Subchapter S election.

- All shareholders must be individuals who are U.S. residents. Certain trusts and estates may be shareholders, but corporations, partnerships, and non-resident aliens are barred from holding shares in an S corp.

- The corporation may have no more than 100 shareholders (husband/wife shareholders may be considered one shareholder).
    - A consequence of this is that shares in S corps cannot be traded on stock exchanges—100 shareholders are generally too few to meet the exchanges' listing requirements (see page 226).

- The corporation must have only one class of stock.

The tax code prohibits a few types of corporations, such as banks and insurance companies with certain tax or accounting attributes, from electing S corporation status.

Limited liability company (LLC). This is a relatively new form of entity that combines aspects of the corporate form with elements of traditional partnerships, but is different from either. A limited liability company is not a corporation, and LLCs do not issue shares; instead, the owners are *members* of the LLC.

An LLC is formed under state law, and the laws governing limited liability companies vary from state to state. In most states, LLC status is available to most types of businesses, and LLC membership is open to individuals (including resident aliens) as well as corporations, partnerships, and other business entities. Most states allow single-member LLCs, and it is now very common for corporations, including large, publicly held corporations, to form wholly owned LLCs for particular projects or ventures or to own real estate parcels.

Like corporations, LLCs offer limited personal liability to their owners. However, an LLC requires substantially fewer formalities to run than a corporation. (For example, there is no need to hold annual shareholder meetings, elect directors, maintain a minute book, etc.) The IRS does not recognize LLCs as a federal classification, and an LLC may elect to file either as a corporation or as a partnership (or sole proprietorship, in the case of a single-member LLC). This winning combination of limited liability, reduced formality, and tax flexibility has made the LLC a very popular type of business structure.

There are potential downsides to the LLC form. First, because as an entity type it is far newer than the corporation, the law governing LLCs is far less developed, and the legal rights and responsibilities of LLC members are not always clear. (Although it is not required, LLCs typically adopt a detailed operating agreement that sets out the relationships between members.) This legal uncertainty surrounding LLCs also makes it more difficult to raise venture capital. Growth-stage LLCs that are actively courting outside investors often convert into corporations to facilitate investment and make it easier to issue shares.

Limited partnership (LP). These have become far less common since the advent of the LLC, but they are still used for specific business projects or investment purposes, particularly in the movie industry, real estate development, and oil and gas drilling. A limited partnership has at least one **general partner**, who manages the business and who is personally liable for the liabilities of the LP, and one or more **limited partners**, who contribute capital to the business but are not involved in running it, and whose liability for obligations of the limited partnership is limited to the amount of their contributions. For liability reasons, the general partner is often an LLC, corporation, or other entity with limited liability. Limited partnerships are normally subject to pass-through taxation, like regular partnerships.

Most states have now adopted the Revised Uniform Limited Partnership Act (RULPA), which sets out the rules for limited partnerships. Unlike a general partnership, which can be formed even if the partners don't intend to form a partnership, a limited partnership must register with the appropriate state authority and may be required to file annual reports. The rights of the partners are governed by a limited partnership agreement, which usually specifies the allocations of profit and loss among the partners. The agreement may also restrict the ability of limited partners to withdraw or to transfer their ownership interests.

Limited partnership interests are considered securities, and are subject to all the registration and associated requirements for the sale of securities. To avoid the need for registration, limited partnership interests are often offered only to accredited investors.

Most limited partnerships are private. **Master limited partnerships (MLPs)**, however, are publicly traded on exchanges and may have hundreds of limited partners, including mutual funds and institutional investors. Qualifying MLPs are not subject to entity-level tax. Unlike many private LP interests, MLP interests are typically freely transferable.

Business trust. A business trust is an unincorporated business entity that is usually formed to hold real estate, securities, commodities, or other assets for business or investment purposes. The assets are held in trust and managed by trustees on behalf of the beneficial owners. The beneficial owners—investors, in other words—receive transferable certificates showing their interest in the trust assets, and the beneficiaries have limited liability. Business trusts are formed under state law. They are sometimes called

Massachusetts trusts or Delaware statutory trusts, even if they are formed in a different state. Trusts can be structured to allow for pass-through taxation.

Many mutual funds and other types of investment companies are structured as trusts. A business trust should not be confused with other types of trusts, such as philanthropic trusts or trusts used for estate planning purposes.

Real estate investment trust (REIT). As you would guess from the name, this is an entity that invests in real estate. Much like a mutual fund for real estate, REITs allow individual and institutional investors to invest indirectly without taking direct ownership of the underlying properties.

A REIT is not technically an organizational structure, but is rather a tax designation available to entities—typically corporations or trusts—that meet certain requirements. The most important of these is the requirement that the entity pay out at least 90% of its taxable income to its investors every year, mostly as dividends. This makes REITs attractive to income investors.

In addition, at least 75% of the entity's assets must be invested in real estate, and 75% of its gross income must be derived from investments in real estate or mortgages on real property. Ninety-five percent of its gross income must be derived from investments in real estate or mortgages on real property or other investments. There are other requirements relating to the number of shareholders and the concentration of ownership. Assuming the entity meets all IRS requirements, it qualifies as a REIT. REITs are pass-through entities and can therefore avoid double taxation on income distributed to shareholders.

REITs typically invest in commercial properties or large developments, such as shopping malls, hotels, office buildings, and multi-family housing. A REIT may concentrate on a particular type of property or a particular geographic region. REITs may be privately or publicly held; public REITs trade on major exchanges or over the counter.

There are three main types of REITs:

1. **Equity REITs** invest directly in real estate and generate income through the collection of rent. This is the most common type of REIT.

2. **Mortgage REITs** lend money directly to developers or owners of properties, or invest in securities secured by real estate mortgages. Their income consists of payments of principal and interest.

3. **Hybrid REITs** combine the attributes of equity and mortgage REITs. These entities invest directly in real estate and lend money to finance real property transactions.

Remember: The two major advantages of investing in REITs are related. First, they are pass-through entities. Second, paying high dividends helps them keep their pass-through status.

Hedge funds and **private equity (PE) funds.** Although the investment strategies of the two types of funds usually differ, hedge funds and private equity funds are entities formed for the express purpose of pooling capital to make investments and are usually open only to wealthy investors. As with REITs, hedge funds and PE funds are not organizational structures in and of themselves. For tax reasons, they are usually formed as limited partnerships or LLCs in which the investors are limited partners or members.

Hedge funds may be formed "onshore" (most often in Delaware) or "offshore" in places like the Cayman Islands. Offshore hedge funds may be formed as foreign business corporations.

SUMMARY

COMMON BUSINESS STRUCTURES

Entity Type	Attributes
C Corporation	• Primary organizational structure for large and medium-sized businesses and for publicly held companies • Corporation formed at state level; issues shares of stock to shareholders (owners) • No qualification requirements for shareholders and shares are freely transferable (subject to securities laws) • Shareholders have limited liability for company debts • Unlimited length of existence • Corporations treated as "persons" for many purposes • Subject to *double taxation*: profits taxed at entity level, dividends are taxable to shareholders
S Corporation	• Not separate type of entity; is corporation that has elected to be taxed on pass-through basis under IRC Subchapter S • Not subject to double taxation: all income and loss passes through to shareholders for tax purposes • Some types of corporations (e.g., banks) ineligible for S corporation status • Shareholders must be individual U.S. residents; corporations, partnerships, non-resident aliens not eligible • 100 shareholders maximum • May only have one class of stock
Limited Liability Company	• Formed under state law • Does not issue shares; owners are members • Members have limited liability for company debts • Requires fewer formalities than a corporation • Can elect either corporate or pass-through taxation • Less established as entity type than corporation; harder to raise venture capital
Limited Partnership	• Used mainly for specific projects in entertainment, real estate, and oil and gas industries • Formed under state law • Managed by at least one *general partner* with personal liability for limited partnership debts (general partner is often an LLC) • One or more *limited partners* contribute capital to business, but do not manage the business and have limited liability • Normally subject to pass-through taxation • Limited partnership interests are considered securities • Most limited partnerships are private; *master limited partnerships* (MLPs) are publicly traded

SUMMARY

COMMON BUSINESS STRUCTURES

Entity Type	Attributes
Trust	• Unincorporated business entity formed under state law • Usually holds assets for business or investment purposes; managed by trustees on behalf of investors • Ownership represented by certificates; owners have limited liability • Can be structured to allow for pass-through taxation • Many mutual funds and other companies structured as trusts
Real Estate Investment Trust (REIT)	• Not an entity type; is a tax designation available to a business entity (e.g., corporation or trust) • Must invest at least 75% of assets directly or indirectly in real estate • Must derive at least 95% of gross income from real estate or other investments • Must pay out at least 90% of taxable income to investors each year • If IRS requirements met, qualify for pass-through taxation • May be privately held or publicly traded
Hedge Fund/Private Equity Fund	• Formed to pool capital of wealthy investors • Usually formed as limited partnerships or limited liability companies; may be based "onshore" or "offshore"

2.7. CAPITAL STRUCTURES

A fundamental question for every company that is trying to raise capital is whether to use debt, equity, or some combination of both as a source of finance. A company's **capital structure** is the extent to which it relies on debt vs. equity financing—how much of its capital comes from selling shares, and how much from selling bonds or taking on other forms of debt.

Equity. Equity financing essentially means selling a portion of the company. Funds from equity financing do not need to be paid back, making this an essential source of financing for high-growth companies. At the same time, it is usually a more expensive way to raise capital than debt financing because one is giving up ownership and there is no tax deduction similar to the one for repaying debt. The viability and relative appeal of equity financing depends on the type of business, its prospects for growth and profitability, and the state of the equity markets at the time of the proposed transaction.

Debt. Debt financing raises capital by incurring debt the company must repay. But debt financing offers an advantage that equity financing does not: the repayment of debt is tax deductible. Virtually every business relies on debt in some form, usually in the form of a bank loan or line of credit, but significant debt financing usually involves the issuance of a debt security such as a note or bond. This form of debt is often less expensive than the issuance of equity. However, the company must generate enough earnings to service the debt, and early-stage or high-growth companies may not be able to rely on debt exclusively to meet their capital requirements. Prevailing interest rates affect a company's ability to rely on the debt markets. Broadly speaking, when interest rates are low, debt is relatively more attractive.

Hybrid. Hybrid financing is the issuing of securities that combine aspects of debt and equity, known as **hybrid securities**. One such hybrid security is convertible preferred stock, which pays dividends in a manner somewhat like a bond's interest payments, but is convertible to common stock at the option of the holder. Hybrid securities are often used by young companies with good growth prospects.

2.8. OFFERING STRUCTURES

Public. A **public offering** is an offering of securities to the investing public. Public offerings must be registered with the SEC, and publicly held companies are subject to disclosure requirements. Public offerings are typically underwritten by one or more investment banks, and once issued, the securities may generally be freely traded. Chapters 6–9 discuss the public offering process in detail. The various types of public offerings are discussed on page 205.

Private. A private offering, also called a **private placement**, is a placement of securities with a discrete set of investors, typically institutional investors. Private placements are generally smaller than public offerings. They often employ a **private placement agent**, or simply a **placement agent**, in a role similar to that of an underwriter. As long as they meet certain requirements, private placements are exempt from registration with the SEC. Securities issued in a private placement typically come with restrictions on transfer. Private placements are discussed in Chapter 10.

Private investment in public equity (PIPE) transaction. Also called a **PIPE offering** or just a **PIPE**, this is a private placement conducted by a company that is already publicly traded. In a typical PIPE transaction, one or more institutional investors buy the issuer's stock in a private placement, at a discount from the market price. Normally, stocks sold in a private placement cannot immediately be resold on the open market, making them illiquid investments. However, as part of the PIPE agreement, the issuer pledges that it will register the securities with the SEC after the transaction is complete. As with other private placements, shares sold in a PIPE don't *have* to be registered, but registering them removes the restriction on reselling the shares. Because the issuer is registering the shares voluntarily, it has a degree of control over the timing of the registration that issuers normally don't enjoy. By choosing to wait until after the sale to register the shares, the issuer gets the flexibility of a private placement, while the investors get the liquidity of shares purchased in a public offering (once the registration becomes effective).

A company typically files an 8-K to report the PIPE transaction to shareholders and the SEC. Because a PIPE transaction can have a dilutive effect on earnings per share, stock exchanges have additional notification requirements for PIPEs. For example, Nasdaq requires issuers to file a notification within 10 days after the transaction if the PIPE increased the company's shares outstanding by more than 5%. If an issuer is selling more than 20% of its outstanding common stock in a PIPE transaction, the exchanges require the shares to be sold at or above the fair market price unless the company obtains shareholder approval to sell for less.

Standby Equity Distribution Agreement (SEDA). This is a variation on a PIPE in which the buyer is pre-arranged. In a SEDA, a publicly traded company privately issues new stock, and an institutional investor agrees to purchase it at a discount to the market price (usually a 5% discount). The issuer may sell all, part, or none of the shares. The shares will usually be issued in groups called tranches, with each tranche corresponding to a specified period of time. The issuer chooses at that time whether to sell that tranche to the buyer, based on the market price and the issuer's financing needs.

Registered direct offering (RDO). An RDO is an alternative to both traditional public offerings and PIPEs. In an RDO, a company issues securities, typically common stock, to a small number of investors pursuant to an existing shelf registration (discussed on page 206). The issuer usually seeks the assistance of a placement agent, who places the securities with institutional investors on a "best efforts" basis. The placement agent assists in keeping the offering confidential, which helps prevent the downward pricing pressure on the issuer's stock that often accompanies public offerings.

While the RDO process resembles private placements in many respects, an RDO is still a public offering. Consequently, the stock is usually not subject to restrictions on resale, and unlike a PIPE offers investors the advantage of immediate liquidity.