



# Investment Funds in United States: Regulatory Overview

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This Q&A is part of the PLC multi-jurisdictional guide to investment funds. It provides a high level overview of investment funds in the United States, looking at both retail funds and hedge funds. Areas covered include a market overview, legislation and regulation, marketing, managers and operators, restrictions and requirements, tax and upcoming reform.

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## RETAIL FUNDS

1. What is the structure of the retail funds market? What have been the main trends over the last year?

### Open-ended retail funds

Open-ended retail funds, commonly referred to as mutual funds, are pooled investment vehicles that generally offer shares to the public on a continuous basis. Open-ended retail funds issue redeemable securities, which means that except in extraordinary circumstances, on shareholder demand a mutual fund must:

- Redeem its shares at net asset value (NAV).
- Pay redemption proceeds within seven days.

Exchange-traded funds (ETFs) are an exception. Although typically organised as open-ended funds, their shares trade on an exchange.

The mutual fund market is well-developed and active (source: *Investment Company Institute statistics, November 2012*):

- There were over 7,600 United States (US) mutual funds with combined assets of over US\$12.8 trillion. Of this, over US\$2.6 trillion was invested in money market funds.
- The combined assets of US ETFs were almost US\$1.3 trillion, a 23.9% increase from 2011.

### Closed-ended retail funds

Closed-ended retail funds, which are often sold in underwritten public offerings, do not offer redeemable securities. Investors generally buy and sell shares of closed-ended funds in the secondary market on exchanges.

The closed-ended fund market is also well-developed and active. As at 30 September 2012, there were 612 US closed-ended funds with over US\$261 billion in assets under management (source: *Investment Company Institute statistics*).

## Regulatory framework and bodies

2. What are the key statutes, regulations and rules that govern retail funds? Which regulatory bodies regulate retail funds?

### Open-ended retail funds

**Regulatory framework.** The Investment Company Act of 1940 (ICA) is the primary source of applicable law. The ICA:

- Imposes substantive requirements on funds' organisation and operation.
- Empowers the Securities and Exchange Commission (SEC) to regulate funds' activities (see below, *Regulatory bodies*).

Mutual funds are also subject to other federal and state laws, including the:

- Securities Act of 1933 (Securities Act), which governs the sale of shares and regulates the form and content of registration statements for sales to the public.
- Securities Exchange Act of 1934 (Exchange Act), which governs the form and content of proxy statements.
- Internal Revenue Code of 1986 (IRC), which imposes requirements on funds wishing to take advantage of the favourable tax treatment afforded to regulated investment companies.
- Commodity Exchange Act (CEA), which governs fund sponsors and advisers if the fund can trade in commodity interests.

**Regulatory bodies.** The following regulatory bodies are applicable:

- **SEC.** This is the principal regulatory body for mutual funds.
- **Financial Industry Regulatory Authority (FINRA).** This is a self-regulatory organisation overseeing securities firms doing business in the US. Regulations promulgated by the FINRA govern FINRA members' sales and marketing of fund shares.

- **The Commodity Futures Trading Commission (CFTC).** This regulates futures, options and swaps markets in the US (and mutual funds that invest in these markets) and their advisers. Funds regulated by the SEC may also be subject regulation from the CFTC.

### Closed-ended retail funds

**Regulatory framework.** Closed-ended funds are generally subject to the same regulatory regime as mutual funds (*see above, Open-ended retail funds*). Closed-ended funds with shares listed on an exchange are also subject to the exchange's rules (as are ETFs).

**Regulatory bodies.** *See above, Open-ended retail funds: Regulatory bodies.*

3. Do retail funds themselves have to be authorised or licensed?

### Open-ended retail funds

A mutual fund must register as an investment company under the ICA and, if it offers its securities to the public, the offering must be registered under the Securities Act.

**Form N-1A and Form N-8A.** A mutual fund must file a notification of registration on Form N-8A and a registration statement on Form N-1A. Form N-1A requires disclosure regarding, among other things:

- The fund's investment objective(s), strategies and related risks.
- Fees and annual fund operating expenses.
- Performance information.
- The fund's adviser(s).
- How to purchase shares.

**SEC review.** As part of the registration process, the SEC staff typically reviews and provides comments on a fund's registration statement. Responses to these comments can be incorporated into one or more pre-effective amendments (amendments made before the fund offers shares to the public). Once the SEC staff is satisfied with the form and content of the registration statement, the SEC will either:

- Declare the registration statement to be effective.
- Allow the fund to file an amendment that becomes effective in due course.

Mutual funds can only offer their securities to the public under an effective registration statement.

**Registration statement updates.** A mutual fund must annually update its registration statement by filing a post-effective amendment on Form N-1A. This updates performance, fee and expense information, as well as any other outdated information. Additionally, most states require mutual funds to make annual notice filings and to pay fees if the fund's shares are sold in that state.

**Fees.** A mutual fund does not pay any upfront fees to the SEC for filing or amending its registration statement, but typically pays fees annually after the fund's financial year-end. Fees are based on the value of shares sold.

**Non-US funds.** It is difficult and uncommon for a fund organised outside the US to register as a mutual fund. The ICA prohibits a foreign fund from offering shares in the US except under an exemptive order. The SEC (in special circumstances or arrangements) can grant an exemptive order, provided that:

- It is both legally and practically feasible to enforce effectively the provisions of the ICA against the foreign fund.
- The issuance of the order is otherwise consistent with the public interest and the protection of investors.

The SEC has issued exemptive rules that make it easier for Canadian funds to register under the ICA, subject to conditions. Foreign funds offered in the US may have unfavourable tax consequences for US investors.

**CFTC registration.** A mutual fund adviser investing in futures, options on commodities or futures, or swaps may be a commodity pool operator (CPO) under the CEA. Previously, many mutual funds relied on an exclusion from the definition of a commodity pool and were therefore exempt from regulation. However, from 31 December 2012, the CFTC has narrowed the scope of this exclusion. Therefore, if a mutual fund is a commodity pool and does not meet certain *de minimis* trading and marketing thresholds, the mutual fund's investment adviser must register with the CFTC (*see Question 14*).

### Closed-ended retail funds

The registration process for closed-ended funds is generally the same as for mutual funds, except that a closed-ended fund:

- Files its registration statement on Form N-2.
- Is exempt from the requirement to update its registration statement annually if it includes certain information in its annual shareholder reports.
- Must pay upfront filing fees based on the amount of the offering.

FINRA typically must review in advance and raise no objections to the underwriting compensation and related arrangements for the distribution of closed-ended funds' shares. Closed-ended funds that list their shares on an exchange are also subject to the exchanges' registration requirements.



## Marketing

4. Who can market retail funds?

### Open-ended retail funds

Mutual funds typically offer their shares to the public through a distributor registered with the SEC as a broker-dealer under the Exchange Act. Distributors are also members of FINRA and subject to FINRA's rules and regulations. The distributor purchases shares from the fund and then sells the shares to the public directly or indirectly through financial intermediaries.

The ICA limits the use of fund assets to pay for the distribution of its shares. Generally, a fund cannot use fund assets to finance distribution unless the fund has adopted a written plan under Rule 12b-1 of the ICA. In 2010, the SEC proposed significant changes to Rule 12b-1, but the timing of their enactment remains uncertain. Due to the difficulties in registering a foreign fund with the SEC (see *Question 3*), foreign funds are limited to making a private placement in the US.

### Closed-ended retail funds

Closed-ended funds typically offer shares through a broker-dealer in a single underwritten public offering. After the public offering, the shares of most closed-ended funds are traded on exchanges. (The shares of most ETFs are also traded on exchanges.) As is the case for open-ended funds (see above, *Open-ended retail funds*), foreign funds are limited to making a private placement in the US.

5. To whom can retail funds be marketed?

### Open-ended retail funds

Generally, mutual funds that have registered a public offering of their shares can offer and sell their shares to any investor. However, mutual funds can restrict sales to certain investors, for example to comply with or to avoid the application of certain anti-money laundering laws.

Mutual funds can also adopt policies, such as frequent trading policies, that can result in sales restrictions on certain investors. Additionally, broker-dealers selling the fund's shares can be subject to FINRA requirements regarding the suitability of the fund's shares for a particular investor.

Mutual funds that have not registered a public offering of their shares (including foreign funds, see *Question 3*) may be offered to US persons under a private placement exemption under the Securities Act (see *Question 18*).

### Closed-ended retail funds

See above, *Open-ended retail funds*.

## Managers and operators

6. What are the key requirements that apply to managers or operators of retail funds?

### Open-ended retail funds

Mutual fund advisers, including foreign advisers, are subject to the Investment Advisers Act of 1940 (Advisers Act) and the ICA. Among other things, these Acts require a mutual fund adviser to:

- Register as an investment adviser with the SEC.
- Adopt written compliance policies and procedures.
- Act in the best interests of its clients.
- File periodic reports with the SEC and maintain certain records.
- Seek the best execution for portfolio transactions.
- Obtain board and shareholder approval of advisory contacts with the fund.

Advisers of mutual funds (including foreign advisers) are subject to the CEA. Depending on the investment programs of the mutual funds, advisors of mutual funds may be required to register as a CPO or commodity trading adviser with the CFTC (see *Questions 3 and 14*).

### Closed-ended retail funds

See above, *Open-ended retail funds*.

## Assets portfolio

7. Who holds the portfolio of assets? What regulations are in place for its protection?

### Open-ended retail funds

A mutual fund must place and maintain its assets with a qualified custodian (*ICA*), typically either a:

- US bank meeting certain capital requirements.
- Broker-dealer.

If certain conditions are met, the fund can act as its own custodian. Rules under the ICA also permit the use of:

- Securities depositories.
- Futures commission merchants.
- Commodity clearing organisations.
- For foreign assets:
  - government-regulated foreign banks;
  - subsidiaries of US banks or bank holding companies;
  - foreign securities depositories.

### Closed-ended retail funds

See above, *Open-ended retail funds*.

### Legal fund vehicles

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures?

### Open-ended retail funds

**Legal vehicles.** A mutual fund or ETF can be organised as:

- A business or statutory trust.
- A corporation.
- A limited partnership.
- A limited liability company (LLC).
- Another entity under the laws of any US state.

Participants' interests in a fund are commonly referred to as shares. A mutual fund can offer multiple classes of shares, subject to different expenses and offering different services, such as different shareholder servicing or distribution arrangements.

**Advantages.** In practice, most mutual funds are set up as one of the following:

- Massachusetts business trusts.
- Delaware statutory trusts.
- Maryland corporations.

These forms of organisation are attractive to fund sponsors because they:

- Offer significant governance flexibility.
- Do not require annual shareholder meetings.

Liability and indemnification issues can also influence the fund sponsor's choice of vehicle.

**Disadvantages.** There are no material disadvantages to the use of these forms of organisation.

### Closed-ended retail funds

**Legal vehicles.** Closed-ended funds are typically organised in the same manner as open-ended funds (*see above, Open-ended retail funds: Legal vehicles*). Unlike open-ended funds, closed-ended funds can issue preferred stock, subject to certain conditions.

**Advantages.** The same advantages apply as for open-ended funds (*see above, Open-ended retail funds: Advantages*).

**Disadvantages.** *See above, Open-ended retail funds: Disadvantages.*

### Investment and borrowing restrictions

9. What are the investment and borrowing restrictions on retail funds?

### Open-ended retail funds

Mutual funds are subject to many restrictions on investments under the ICA, including:

- Limitations on the maximum investment in a single issuer for diversified funds:
  - in relation to 75% of its assets, a diversified fund cannot invest more than 5% of those assets in a single issuer and cannot acquire more than 10% of the outstanding voting securities of a single issuer;
  - the remaining 25% of the diversified fund's assets are not subject to this limitation and can be invested in a single issuer.

These limitations do not apply to US government securities and securities of other investment companies.

- Restrictions on transactions with affiliates.
- Limitations on investments in other investment companies, securities-related businesses and illiquid securities.

Money market funds have additional restrictions on portfolio quality, diversification, maturity and liquidity.

A fund must also disclose in its registration statement its investment policy in relation to certain matters, such as the purchase and sale of real estate and commodities. These investment policies cannot be changed without shareholder approval.

A mutual fund is limited in its ability to borrow money. A mutual fund cannot issue senior securities, which the ICA defines as any:

- Bond, debenture, note or similar obligation constituting a security and evidencing indebtedness (although bank borrowings are permitted as described below).
- Stock of a class having priority over any other class as to distribution of assets or payment of dividends.

A mutual fund can borrow money from a bank, but must maintain certain asset coverage in relation to these borrowings. The SEC is of the view that certain trading practices and derivative instruments must be covered either by asset segregation or offsetting transactions.

### Closed-ended retail funds

Closed-ended funds are generally subject to the same restrictions as mutual funds. However, a closed-ended fund can issue a senior debt security and a senior equity security, subject to asset coverage requirements.

10. Can the manager or operator place any restrictions on the issue and redemption of interests in retail funds?

### Open-ended retail funds

A manager/operator can place restrictions on the issue of interests in retail funds. For example, a fund can:



- Close (or close a share class) to new purchasers.
- Establish minimum investment amounts.
- Impose front-end, level or deferred sales charges.
- Limit the distribution channels through which shares are sold.
- Limit the ability of frequent traders to purchase shares or otherwise limit the number of exchanges an investor can make within a specified period.

A mutual fund cannot suspend redemptions except under unusual circumstances (such as when the New York Stock Exchange is unexpectedly closed or trading is restricted, or the SEC has declared an emergency). However, it can impose a redemption fee of up to 2%.

### Closed-ended retail funds

Closed-ended fund shares are not redeemable at the shareholder's option. However, a closed-ended fund can:

- Impose a sales charge on its initial sale of shares.
- Repurchase its shares, including at a price other than NAV.

11. Are there any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties?

### Open-ended retail funds

There are no statutory restrictions on mutual fund investors' rights to transfer or assign their rights to third parties. However, most investors seeking to dispose of their shares either:

- Redeem them.
- In the case of ETFs, sell them on an exchange.

### Closed-ended retail funds

There are no statutory restrictions on closed-ended fund investors' rights to transfer or assign their rights to third parties. However, most investors seeking to dispose of their shares sell them on an exchange.

### Reporting requirements

12. What are the general periodic reporting requirements for retail funds?

### Open-ended retail funds

**Investors.** Mutual funds must deliver the following reports to investors:

- A prospectus or summary prospectus.
- Supplements to the fund's prospectus.
- Annual and semi-annual reports.
- Annual privacy notices.

- Certain tax information.

**Regulators.** Mutual funds must file the following reports, among others, with the SEC:

- Annual updates to the fund's registration statement on Form N-1A.
- Supplements to the fund's prospectus.
- Annual and semi-annual reports on Form N-CSR, containing the fund's financial statements and certified by the fund's CEO and CFO.
- Semi-annual reports on Form N-SAR, containing certain regulatory information.
- Quarterly reports on Form N-Q, containing portfolio holdings information and certified by the fund's CEO and CFO.
- Annual reports on Form N-PX regarding the fund's proxy voting record.
- In relation to money market funds, Form N-MFP, containing information regarding a money market fund's portfolio holdings.

Mutual funds can be required to make periodic filings with state securities regulators.

### Closed-ended retail funds

**Investors.** Closed-ended funds must deliver the same periodic reports to investors as mutual funds (*see above, Open-ended retail funds: Investors*). A closed-ended fund's annual report typically includes the information that otherwise would be required in an updated Form N-2.

**Regulators.** Closed-ended funds must file the same periodic reports with the SEC as mutual funds (*see above, Open-ended retail funds: Regulators*). A closed-ended fund's annual report on Form N-CSR typically includes the information that otherwise would be required in an updated Form N-2.

### Tax treatment

13. What is the tax treatment for retail funds?

### Open-ended retail funds

**Funds.** Funds typically seek to qualify as regulated investment companies under the IRC. A regulated investment company is not subject to federal income tax at the fund level on income and gains from investments that are distributed in a timely manner to investors, provided the regulated investment company satisfies certain ongoing qualification tests under the IRC.

**Resident investors.** Generally, for federal income tax purposes, a fund's distribution of investment income and net short-term capital gains (that is, the excess of net short-term capital gains over net long-term capital losses) is taxable to resident investors as ordinary income. Distributions of net capital gain (that is, the excess of net long-term capital gains over net short-term capital losses) that are properly reported by the fund as capital gain dividends are taxable to resident investors as long-term capital gains.



Distributions of investment income reported by the fund as being derived from qualified dividend income are taxable to resident investors at the rates applicable to long-term capital gains, provided certain holding period and other requirements are met at both the fund and investor level. Resident investors can also be subject to state and local taxes on any of these distributions. Any gain resulting from an exchange or redemption of fund shares is generally subject to tax as a long-term or short-term capital gain, depending on the period of time the investor held the shares.

Top marginal federal income tax rates for individuals are currently:

- 39.6% for ordinary income and short-term capital gains.
- 20% for long-term capital gains.

In addition, from 1 January 2013, a 3.8% Medicare contribution tax is imposed on the net investment income of certain resident individuals whose income exceeds certain thresholds, and certain trusts and estates under similar rules. Net investment income generally includes:

- Dividends paid by a fund.
- Any net gain resulting from an exchange or redemption of fund shares.

**Non-resident investors.** In general, dividends (other than capital gain and exempt-interest dividends) paid to an investor that is not a US person within the meaning of the IRC (non-US investor) are subject to withholding of US federal income tax at a rate of 30% (or any lower applicable treaty rate). Under a special IRC exemption, distributions paid to a non-US investor of US source interest income or net short-term capital gains generally are exempt from withholding, provided the fund reports them as such to investors. This special exemption will expire for taxable years of a fund beginning after 31 December 2013, unless the US Congress extends the effective date, as it has done in the past. Generally, non-US investors are not subject to US federal income tax on gains realised on the exchange or redemption of fund shares.

From 1 January 2014, a separate 30% withholding tax will be payable on distributions by a fund to certain investors that fail to comply with the Foreign Account Tax Compliance Act (FATCA) (see *Question 14*).

### Closed-ended retail funds

**Funds.** See above, *Open-ended retail funds*.

**Resident investors.** See above, *Open-ended retail funds*.

**Non-resident investors.** See above, *Open-ended retail funds*.

### Reform

14. What proposals (if any) are there for the reform of retail fund regulation?

Recent legal changes potentially affecting retail funds include:

- The adoption by the US Congress of a set of rules under FATCA. Under FATCA, a separate 30% withholding tax on certain payments of US source income and gross proceeds will be phased in from 1 January 2014.

Under certain circumstances, resident and non-resident investors will be subject to this tax if they (or any non-US banks or other non-US financial intermediaries through which they own their shares) fail to comply with FATCA (or an applicable intergovernmental agreement), or otherwise fail to provide a fund with appropriate certifications or other documentation concerning their FATCA status, in relation to:

- dividends paid by a fund; or
- gross proceeds recognised on the disposition of fund shares.
- The adoption of amendments narrowing the exclusion from the definition of CPOs. Funds investing in the futures, options and swaps markets that do not meet certain *de minimis* trading and marketing thresholds may be regulated as commodity pools, in which case their investment advisers must register as CPOs and/or commodity trading advisers (CTAs). In addition, funds that do not meet the applicable thresholds are subject to other CFTC requirements (such as disclosure, recordkeeping and reporting requirements).

The CFTC's requirements are currently not consistent with the SEC's requirements and the industry is awaiting "harmonisation provisions" to make these provisions consistent (funds are not required to comply with the CFTC's requirements until these are harmonised with the SEC's requirements).

- The adoption of amendments to the rules governing money market funds, which are meant to reduce the risks associated with a money market fund's portfolio. In addition, there is a continuing discussion regarding whether to impose floating NAVs or capital buffers for money market funds.
- The SEC has issued a concept release (an SEC-approved document that poses ideas to the public to solicit their views) on the use of derivatives by investment companies, indicating interest in reconsidering the application of the ICA to funds' use of derivatives.
- The proposal of a new rule and related amendments to replace Rule 12b-1 under the ICA, which would limit cumulative sales charges paid by an investor.
- The Supreme Court's ruling in *Jones v Harris Associates LP* (130 S.Ct. 1418 (U.S. 2010)), which established the standard governing claims of excessive fees under the ICA.



## HEDGE FUNDS

15. What is the structure of the hedge funds market? What have been the main trends over the last year?

The US hedge fund market is well developed and actively populated by many managers, funds and high net-worth and institutional investors. US hedge fund managers also manage significant assets of non-US investors. As of 30 September 2012, total industry assets reached an estimated US\$2.19 trillion (source: *Hedge Fund Research*).

Hedge funds generally experienced solid performance in 2012. The return of the AR Composite Index, a broad measure of hedge fund performance maintained by industry magazine *AR*, was estimated to be 6.48% for the 2012 calendar year.

### Regulatory framework and bodies

16. What are the key statutes and regulations that govern hedge funds in your jurisdiction? Which regulatory bodies regulate hedge funds?

#### Regulatory framework

The Advisers Act is the primary source of law applicable to hedge fund managers. The Advisers Act imposes substantive requirements on advisers and empowers the SEC to regulate advisers' activities. In addition to the statutes described in *Question 2*, hedge funds and their managers are subject to other federal and state laws, including the:

- Employee Retirement Income Security Act 1974, which governs the management of pension money.
- CEA, which regulates hedge fund managers if the fund invests in futures, options and/or swaps.
- Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), which, among other things:
  - substantially alters the registration and reporting schemes under the Advisers Act;
  - places new restrictions on banks; and
  - imposes new requirements on over-the-counter (OTC) derivatives markets and transactions.

See also *Question 26*.

Hedge funds are typically eligible for an exemption from certain federal securities laws, including the ICA and Securities Act (see *Question 19*).

### Regulatory bodies

17. How are hedge funds regulated (if at all) to ensure compliance with general international standards of good practice?

The SEC regulates the activity of advisers to funds (see *above*, *Regulatory framework*). Also, the CFTC regulates advisers and operators of funds that invest in commodities, futures and certain OTC derivatives.

#### Risk

Several federal regulators, including the Financial Stability Oversight Council, the Federal Reserve Board of Governors, the CFTC and the SEC, monitor systemic risk of financial institutions including hedge funds (*Dodd-Frank*). Fund offering documents typically list risk factors related to an investment in the fund.

#### Valuation and pricing

The SEC emphasises valuation and pricing. Funds generally value securities in accordance with US generally accepted accounting principles (GAAP).

#### Systems and controls

All registered advisers must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act and its rules (*Advisers Act*).

#### Insider dealing and market abuse

Hedge fund managers must not engage in market manipulation and insider trading (*Securities Act*, *Exchange Act* and *Dodd-Frank*). Registered advisers must adopt and implement written policies and procedures designed to prevent insider trading.

#### Transparency

Limited reporting of public securities holdings is required (see *Question 22*). In addition, the SEC can require additional reporting, including rules for the assessment of systemic risk (*Dodd-Frank*) (see *below*, *Short selling*).

#### Money laundering

Most hedge fund managers maintain some sort of anti-money laundering programme, although they are not required to do so.

In addition, the anti-fraud rules of the Advisers Act apply to all US advisers, regardless of registration status (see *Question 22*).

#### Short selling

The SEC must prescribe rules requiring monthly public disclosure of certain information relating to short sales (*Dodd-Frank*), although these rules have not yet been adopted.

Dodd-Frank prohibits “a manipulative short sale of any security”. The SEC has also adopted a rule requiring stock exchanges to prevent short sales of certain stocks at a price that is lower than the current national best bid price if the price has decreased 10% or more from the closing price on the previous day.

Separately, issuer securities cannot be sold short within a restricted period before purchasing the same securities in the issuer’s secondary public offering (*Rule 105, Regulation M*).

### Marketing

#### 18. Who can market hedge funds?

Persons who sell interests in any hedge funds must be registered as broker-dealers, subject to certain limited exemptions for issuers who market their own securities. Other jurisdictions may apply similar or different regulations with respect to marketing interests in hedge funds.

#### 19. To whom can hedge funds be marketed?

### Regulation D of the Securities Act

Interests in hedge funds are generally offered to US persons under a private placement exemption under the Securities Act.

An offering can be exempt from registration if sales are restricted to accredited investors, generally defined as:

- Persons with a net worth of US\$1 million (with spouse) or annual income of US\$200,000 (US\$300,000 with spouse).
- Businesses and other entity investors with total assets of US\$5 million.

The value of an individual’s primary residence is not included as an asset for purposes of the calculation of net worth.

The SEC has proposed rules to implement the Jumpstart Our Business Startups Act, enacted in April 2012. This Act is expected to allow hedge funds significantly more from in relation to its advertising and marketing, provided all investors are “accredited investors.”

### Regulation S of the Securities Act

Interests in non-US hedge funds may be exempt from registration under the Securities Act if offers and sales are made outside the US to non-US investors, even if those offers and sales are not made in a private placement.

### Investment Company Act

Hedge funds typically operate under one of the following exemptions from ICA registration either:

- Interests are privately offered to, and held by, fewer than 100 US beneficial owners.

- Interests are only privately offered to qualified purchasers, generally:
  - persons with US\$5 million in investments;
  - companies or other institutions with US\$25 million in investments;
  - persons investing solely on behalf of qualified purchasers.

### Commodity Exchange Act

Fund managers that engage in futures, options and/or swaps may be required to register as CPOs and/or CTAs with the CFTC and become members of the National Futures Association (NFA). From 31 December 2012, the CFTC narrowed the available exemptions from the CPO registration requirement, rescinding an exemption on which many fund managers previously relied. As a result, general partners or managers of hedge funds that invest more than a *de minimis* portion of their assets in futures, options on futures, and certain derivatives must register with the CFTC as a CPO. Registered CPOs must comply with various disclosure, record keeping and reporting requirements, as well as with other regulations.

### “Qualified client” rule

An SEC-registered investment adviser is generally prohibited from receiving compensation based on the performance of a client’s account unless the client is a “qualified client”. Hedge funds typically offer interests in hedge funds solely to such “qualified clients”, defined as:

- Persons or companies that have at least US\$1 million under management with the adviser after making the investment.
- Persons or companies that have a net worth of more than US\$2 million prior to their investment.

The SEC’s proposal to exclude the value of an individual’s primary residence from the calculation of net worth is also relevant for the purposes of determining a potential investor’s status as a “qualified client”.

### Investment restrictions

#### 20. Are there any restrictions on local investors investing in a hedge fund?

To avoid regulation as an investment company under the ICA and the registration requirements under the Securities Act, a fund offering interests to investors in the United States must comply with restrictions outlined in *Question 19, Regulation D of the Securities Act* and *Question 19, Investment Company Act*.

In general, a fund that is organised outside the United States must only count its US investors to determine if:

- It has fewer than 100 beneficial owners.
- All of its investors are qualified purchasers.





## Assets portfolio

21. Who holds the portfolio of assets? What regulations are in place for its protection?

Registered advisers must engage a qualified custodian (such as a bank, registered broker-dealer or other financial institution) to hold client assets.

Managers can be exempt from all of the following requirements to:

- Deliver quarterly account statement.
- Provide notice of the qualified custodian.
- Arrange for surprise audits.

This exemption applies if they:

- Engage an independent public accountant to perform an annual audit. The accountant must be registered with, and subject to regular inspection by, the Public Company Account Oversight Board.
- Distribute financial statements prepared in accordance with GAAP within 120 days (or 180 days for funds of funds) of the end of the fund's fiscal year.

Additional rules apply when an affiliate acts as qualified custodian.

## Requirements

22. What are the key disclosure or filing requirements (if any) that must be completed by the hedge fund?

Hedge funds and their advisers must make public filings, including of the following, among other things:

- Ownership in public companies above certain specified thresholds set out in the Exchange Act.
- Certain exchange traded equity securities, equity options/warrants, shares of closed-ended funds and convertible debt securities (only for advisers qualifying as institutional investment managers with a discretion of over US\$100 million in those securities).
- Certain large positions.
- Form D filings to disclose initial and annual sales of fund interests in the US.
- Filings with states under Blue Sky laws.
- Filings with the Internal Revenue Service.
- Form ADV, the form used by investment advisers to register with the SEC, which requires certain disclosure about:
  - the types of services offered by an investment adviser;
  - the adviser's fee schedule;
  - disciplinary information relevant to the adviser or its employees;

- conflicts of interest;
- the educational and business background of management and key advisory personnel of the adviser.

In addition, the SEC has adopted substantial new reporting obligations with respect to hedge funds under Form PF. These obligations are as follows:

- Hedge fund advisers must file Form PF with the SEC annually.
- Advisers managing hedge funds (including certain separately managed accounts) that collectively have over US\$1.5 billion in assets under management must file this form with the SEC quarterly. Advisers managing hedge funds with between US\$150 million and US\$1.5 billion under management must file annually. Advisers with less than US\$150 million under management attributable to private funds are not required to file Form PF but are subject to less comprehensive disclosure requirements.
- Form PF will require disclosure of the following items, among other things, with respect to each hedge fund:
  - the fund's investment strategy;
  - gross and net assets;
  - percentage of assets managed using high-frequency, computer-driver trading algorithms;
  - largest creditors;
  - notional value of derivatives;
  - number of equity holders;
  - percentage of the fund owned by certain types of investors; and
  - monthly and quarterly performance information.

Funds of funds are permitted to provide only a subset of the Form PF disclosure required of other private funds.

Offering memoranda, marketing materials and side letters are not required to be filed with the SEC but are subject to review by the SEC on examination.

23. What are the key requirements that apply to managers or operators of hedge funds?

All hedge fund managers are subject to Advisers Act anti-fraud provisions. US private fund managers with assets under management above US\$150 million generally must register with the SEC (*Dodd-Frank*) (see *Question 26*). Managers with separate account clients typically must register with the SEC if they have assets under management above US\$100 million. Registration subjects an adviser to various requirements including those relating to custody, advertising, personal trading, record keeping and proxy voting.

Advisers not subject to registration under the Advisers Act can be subject to state registration requirements. Advisers to funds engaging in futures or certain other derivatives transactions can also be subject to registration under the CEA.

Non-US advisers can manage assets of US investors. However, depending on the nature and extent of their US activities, non-US advisers can be required to register with the SEC or otherwise be subject to the Advisers Act in certain respects. Non-US advisers to hedge funds are exempt from registration under the Adviser Act if they:

- Have no place of business in the US.
- Have, in total, fewer than 15 clients and investors in the US in private funds advised by the adviser.
- Have less than US\$25 million of aggregate assets under management attributable to such clients and investors.
- Do not hold themselves out to the public in the US as an investment adviser or advise funds registered under the ICA.

### Legal fund vehicles and structures

24. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures?

US hedge funds are typically structured as Delaware limited partnerships or LLCs. These vehicles afford investors limited liability while providing the manager with broad authority (*Question 26*). Typically, the fund also enters into a separate management agreement with the manager. Investor interests are referred to as limited partnership interests or membership interests.

The typical structures include a master-feeder structure and a parallel fund structure.

#### Master-feeder structure

In a master-feeder structure, one or more “feeder” funds (which often include both a US entity that is treated as a partnership for US tax purposes and a non-US entity treated as a corporation for US tax purposes) invest in a “master” fund, which is typically treated as a partnership for US tax purposes.

The non-US feeder fund, taxable as a corporation, is generally organised in a tax-efficient jurisdiction, such as the Cayman Islands. US taxable investors typically invest in a US feeder fund, and non-US investors and US tax-exempt investors typically invest in the non-US feeder fund.

**Advantages.** The main advantage of a master-feeder structure is that the adviser can manage a single pool of assets.

**Disadvantages.** Because the adviser manages a single pool of assets, the master/feeder structure may not permit the adviser to tailor its management of a pool of assets to address the specific tax considerations of the offshore fund and of the investors in the onshore fund.

#### Parallel fund structure

This is where the manager manages a Delaware limited partnership or LLC, and a non-US corporation, side by side.

The non-US corporation is generally organised in a tax-efficient jurisdiction, such as the Cayman Islands.

Managers can also provide advice to investors through separately managed accounts.

**Advantages.** The main advantage of a parallel fund structure is that the manager can make different investments for the US fund and the non-US fund based on tax or other considerations.

**Disadvantages.** A parallel fund structure may be more complex to operate due to the administrative burdens associated with allocating trades between different pools of assets pursuing a similar strategy and the problems that may arise where, for example, the securities being traded are in short supply.

### Tax treatment

25. What is the tax treatment for hedge funds?

#### Funds

There is no federal entity level tax on domestic/onshore funds, so long as they are treated as partnerships and not as publicly traded partnerships for US income tax purposes (which can be taxable as corporations in certain circumstances). An offshore fund formed as a non-US corporation or partnership that is taxed as a corporation for US income tax purposes is subject to:

- Net-basis US tax and an additional branch profits tax on the fund’s share of income that is, or is treated as, effectively connected with a US trade or business (ECI) conducted by the fund.
- US withholding tax on US corporate dividends and certain other US source income that is not ECI.
- From 1 January 2014, a US withholding tax on a broad range of US-source withholdable payments. This will generally not apply if the fund enters into a withholding/reporting agreement with the US Treasury.

#### Resident investors

For entities treated as a partnership, a taxable US investor reports on its own tax return its distributive share of the fund’s annual taxable income or loss, regardless of whether distributions are received. The tax character of the income or loss also generally passes to the investor.

US taxable investment in offshore entities treated for US tax purposes as corporations is subject to special rules.

#### Non-resident investors

Non-US investors and US tax-exempt entities typically invest through an offshore corporation, generally to avoid:

- For non-US investors, direct US tax on ECI and the obligation to make tax filings in the US.
- For US tax-exempt entities, unrelated business taxable income.

For the relevant tax rates, see *Question 13*.

## Restrictions

26. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

### Redemption of interest

Investors can usually redeem periodically (that is, monthly or quarterly) with prior notice. Redemptions can be subject to:

- Lock-up periods.
- Fees.
- Gates.
- Suspensions.
- Reserves.

### Transfer to third parties

Transfers are typically restricted and require prior approval by the general partner or manager.

## Reform

27. What (if any) proposals are there for the reform of hedge fund regulation?

Dodd-Frank was signed into law on 21 July 2010 for the purpose of preventing future financial crises. It effected sweeping changes to the overall US regulation of the financial services industry, including hedge funds. For example, Dodd-Frank required advisers with at least US\$150 million under management to register as investment advisers with the SEC by 30 March 2012. The SEC has informed newly-registered advisers that it intends to conduct focused examinations of their policies and practices regarding:

- Marketing.
- Allocation of investment opportunities.
- Conflicts of interest.
- Custody.
- Safekeeping of client assets and valuation.

Many other rules have been proposed under Dodd-Frank but have not yet been adopted. These rules include the Volcker Rule, which would limit the proprietary trading and private investment fund activities of US banks and their affiliates, and substantial new regulations on OTC derivatives. Many industry participants have commented on these rules. It is likely that some of these rules will be revised substantially before they are issued in final form. As a result, the full impact of these new requirements remains unclear.

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**Professional qualifications.** Massachusetts, US, 1987; New York, US, 2004

**Areas of practice.** Investment funds.

**Non-professional qualifications.** JD, Yale Law School, 1987; BA Trinity College, 1984

#### Recent transactions

- Represented BlackRock in connection with its acquisition of Swiss Re's fund of funds business.
- Advises investment advisers, broker-dealers, and open-ended and closed-ended funds.
- Advises clients on the organisation of hedge funds, private equity funds and funds of funds (both registered and unregistered), with a particular emphasis on non-US sponsors offering products and services in the US.

**Languages.** English, French

**Professional associations/memberships.** Advisory board, Mutual Fund Directors Forum.

#### Publications

- Co-author, Investment funds: United States, *Practical Law Investment Funds multi-jurisdictional guide*, 2012.
- Co-author, Investment funds: United States, *Practical Law Investment Funds multi-jurisdictional guide*, 2011.

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**Professional qualifications.** Massachusetts, US, 1997

**Areas of practice.** Investment funds and investment advisers.

**Non-professional qualifications.** JD, *magna cum laude*, Harvard Law School, 1997; AB, *summa cum laude*, Dartmouth College, 1994

Recent transactions

- Focusing on regulatory and transactional matters relating to the financial services industry.
- Ongoing representation of investment advisers, open-ended and closed-ended funds and their trustees, and hedge funds and other private investment vehicles.
- Working with clients to structure investment products with an emphasis on alternative investment strategies.
- Representing public and private companies in the financial services and other industries in a variety of matters, including debt and equity offerings, mergers and acquisitions and investment transactions.

Professional associations/memberships

- American Bar Association.
- Boston Bar Association, Co-chair, Investment Companies and Advisors Committee (2008-2011).

Publications

- Co-author, Investment funds: United States, *Practical Law Investment Funds multi-jurisdictional guide*, 2012.
- Co-author, Investment funds: United States, *Practical Law Investment Funds multi-jurisdictional guide*, 2011.

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**Professional qualifications.** New York, US, 1997

**Areas of practice.** Private investment funds and investment advisers.

**Non-professional qualifications.** JD, New York University School of Law, 1996; AB, with High Distinction, University of Michigan, 1993

Recent transactions

- Advising institutional and individual managers worldwide on the most advantageous ways to form, structure and re-organise hedge funds and other private funds.
- Advising clients on matters affecting their ongoing operations, including compensation structures and related profit-sharing arrangements, and regulatory and compliance matters.
- Advising global financial services firms and global alternative investment management companies on the launch of feeder funds, institutional seed investments and managed account arrangements.

Professional associations/memberships

- Board Member, New York University Law Alumni Association, Inc.
- Secretary and General Counsel, High Water Women Foundation.
- Member, Private Investment Funds Committee, New York City Bar Association.
- Member, Legal Peer Advisory Group, 100 Women in Hedge Funds.

Publications

- Co-author, US Chapter: Investment Funds Jurisdictional Comparisons, *The European Lawyer Reference*, 2012
- Co-author, Investment funds: United States, *Practical Law Investment Funds multi-jurisdictional guide*, 2012.
- Co-author, Investment funds: United States, *Practical Law Investment Funds multi-jurisdictional guide*, 2011.



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- Investment funds in Hong Kong: regulatory overview  
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(<http://us.practicallaw.com/7-501-5093>)
- Investment funds in Japan: regulatory overview  
(<http://us.practicallaw.com/0-501-5077>)
- Investment funds in Jersey: regulatory overview  
(<http://us.practicallaw.com/5-501-4947>)
- Investment funds in Malta: regulatory overview  
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- Investment funds in Mexico: regulatory overview  
(<http://us.practicallaw.com/6-521-7384>)
- Investment funds in Portugal: regulatory overview  
(<http://us.practicallaw.com/0-516-9084>)
- Investment funds in Singapore: regulatory overview  
(<http://us.practicallaw.com/9-501-3516>)
- Investment funds in South Africa: regulatory overview  
(<http://us.practicallaw.com/5-504-1111>)
- Investment funds in South Korea: regulatory overview  
(<http://us.practicallaw.com/8-521-7359>)
- Investment funds in Switzerland: regulatory overview  
(<http://us.practicallaw.com/1-501-3469>)
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