

Investment funds in United States: regulatory overview

Bryan Chegwiddden, James Thomas and Sarah Davidoff
Ropes & Gray LLP

global.practicallaw.com/5-501-3486

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, February 2015*):

- There were almost 8,000 United States (US) mutual funds with combined assets of over US\$16 trillion. Of this, over US\$2.7 trillion was invested in money market funds.
- The combined assets of US ETFs were over US\$2 trillion, a 21.2% increase over the past 12 months.

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 31 December 2014, there were 568 US closed-ended funds with almost US\$290 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.
- **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.

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 closed-ended 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 20*).

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 programmes 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 17*).

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 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 or summary 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 or summary 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 (*see Question 15*).

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 individual 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, a 3.8% Medicare contribution tax is imposed on the net investment income of certain resident individuals, estates and trusts to the extent their income exceeds certain thresholds. 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, in the case of certain municipal bond funds, 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 were exempt from withholding, provided the fund reported them as such to investors. This special exemption has expired for taxable years of a fund beginning after 31 December 2014. It is currently unclear whether the US Congress will extend this exemption and what the terms of such an extension would be, including whether such extension would have retroactive effect. Generally, non-US investors are not subject to US federal income tax on gains realised on the exchange or redemption of fund shares.

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).

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.

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*.

Quasi-retail funds

14. Is there a market for quasi-retail funds in your jurisdiction?

There are a number of registered investment companies offering so-called "alternative" strategies to investors. Some of these investment companies are made available only to accredited investors or qualified clients (see *Question 20*), because they are offered in private placements or charge performance fees.

Reform

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

Recent legal changes potentially affecting retail funds include:

- The 20 May, 2015 proposal of rules, forms and amendments to modernise reporting and disclosure of information, including relating to portfolio holding and risk characterisations for investment companies and advisers.
- The 23 July, 2014 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. Key features of the amendments are as follows:
 - require "institutional" prime money market funds to use a floating net asset value;
 - impose default liquidity fees on non-government money market funds when certain conditions are present (unless the fund's board determines otherwise);
 - give money market funds the flexibility to institute liquidity fees and/or redemption gates under certain conditions if the board determines that they are in the best interest of the fund;
 - require additional disclosures regarding the risk factors associated with investing in stable and/or floating net asset value money market funds (including the potential imposition of liquidity fees or redemption gates); and
 - require the filing of new Form N-CR which money market funds must file with the SEC within one business day of the occurrence of certain events (such as the imposition of lifting or liquidity fees or redemption gates).
- The SEC's Office of Compliance Inspections and Examinations has been conducting an examination of practices relating to payments to financial intermediaries, and there is the potential for guidance or other developments in this area.
- 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 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

16. 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 the end of Q1 2015, total industry assets reached an estimated US\$2.94 trillion (source: *Hedge Fund Research*).

Hedge funds generally experienced a mixed performance in 2014, with returns estimated to be 4.19% for the 2014 calendar year (source: *Hedge Fund Intelligence Global Index - Composite*).

Following the coming into force of AIFMD, US marketing in EU jurisdictions involves considerably more compliance time and cost. Private placement in some EU states is still permissible, but a combination of requirements derived from AIFMD (in particular, AIFMD "Annex IV" regulatory reporting and annual remuneration disclosure) and enhanced local laws (in particular, the requirement to appoint a depositary to the fund when marketing in Germany, Denmark or Spain) has increased the cost. The AIFMD does not apply if the investor invests at its own initiative, a reverse enquiry may be a viable route, although its perimeters are unclear.

The SEC has continued to focus on insider trading issues. A recent decision in *United States v. Newman*, 2014 WL 6911278 (2d Cir. Dec. 10, 2014) will make it more difficult for the government to prove tippee liability, where the Second Circuit held that tippee liability requires, among other things, that a personal benefit of some consequence be received by the tipper in exchange for confidential information and the tippee's knowledge that such a benefit had been conferred on the tipper.

Regulatory framework and bodies

17. 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 may be subject to other federal and state laws, including the:

- Employee Retirement Income Security Act 1974 (ERISA), which governs the management of investments by "benefit plan investors" (including pension fund money and individual retirement accounts).
- 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 altered the registration and reporting schemes under the Advisers Act;
 - placed new restrictions on banks under the newly adopted Volcker Rule; and

- imposed new requirements on over-the-counter (OTC) derivatives markets and transactions, including increased transparency.

- Privacy rules adopted by the SEC and the Federal Trade Commission (FTC) under Regulation S-P, Regulation S-AM and similar FTC rules, which prohibit hedge fund managers from disclosing certain non-public personal information about individual fund investors and require protection of such information.
- FINRA rules, which govern a hedge fund's ability to purchase equity securities sold in initial public offerings.

See also *Question 28*.

Hedge funds are typically eligible for an exemption from registration under certain federal securities laws, including the ICA and Securities Act (see *Question 20*).

Regulatory bodies

The SEC regulates the activity of advisers to funds (see *above, Regulatory framework*). The CFTC regulates advisers and operators of funds that invest in futures, options and/or swaps. Also, the US Department of Labor regulates the activity of advisers to funds that are subject to ERISA. Finally, hedge funds are subject to the requirements of the US Office of Foreign Assets Control (OFAC), which requires advisers to ensure that their funds do not permit investments from individual investors, or in particular jurisdictions, on the OFAC list.

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

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*). Also, the US Foreign Corrupt Practices Act of 1977 prohibits advisers and their hedge funds from offering any improper payments to foreign officials in order to obtain their business. 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 23*). The SEC can also require additional reporting, including by prescribing disclosure rules for use in the assessment of systemic risk (*Dodd-Frank*) (see *below, Short selling*). In addition, the SEC has the authority to conduct routine, cause and sweep examinations of registered advisers (see *Question 28*).

Money laundering

Most hedge fund managers maintain some sort of anti-money laundering programme, although they are not currently 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 24*).

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

19. 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, including the requirements of the Alternative Investment Fund Managers Directive (AIFMD), which govern the marketing activities of US advisers that market a hedge fund in the European Economic Area.

20. 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 (*Rule 506(b)*):

- 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); and
 - businesses and other entity investors with total assets of US\$5 million.
- Up to 35 other purchasers that satisfy certain standards of sophistication.

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

Rule 506(c), which was adopted in 2013 as part of the Jumpstart Our Business Startups Act (JOBS Act), created an exemption from registration that allows issuers to engage in "general solicitation" and "general advertising" of an offering, provided that all purchasers are "accredited investors" and certain other conditions are met, including that the issuer takes certain measures to verify purchasers' accredited investor status.

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:

- Interests are privately offered to, and held by, fewer than 100 US beneficial owners (*section 3(c)(1) funds*); or.
- Interests are only privately offered to qualified purchasers (*section 3(c)(7) funds*), which are generally:
 - persons with US\$5 million in investments;
 - companies or other institutions with US\$25 million in investments; and
 - persons investing solely on behalf of qualified purchasers.

Commodity Exchange Act

Fund managers whose hedge funds invest 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). Effective 31 December 2012, the CFTC narrowed the available exemptions from the CPO registration requirement, rescinding an exemption on which many fund managers had 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 and/or swaps 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 (assets under management test); or
- Persons or companies that have a net worth of more than US\$2 million prior to their investment (net worth test).

The net worth test excludes the value of an individual's primary residence and certain property-related debt for the purposes of determining a potential investor's status as a "qualified client".

Investment restrictions

21. 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 20, Regulation D of the Securities Act* and *Question 20, 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

22. 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 statements.
- 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

23. 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 the following, among others:

- Form ADV, the form used by investment advisers to register with the SEC (as well as filings by exempt reporting advisers), which requires certain disclosures 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; and
 - the educational and business background of management and key advisory personnel of the adviser.
- 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 discretion over US\$100 million in those securities).
- Certain large positions (including Form 13H "large trader" filings and other filings with the US Treasury Department, the Federal Reserve Bank System and the Bureau of Economic Analysis where certain thresholds are reached).
- For advisers whose funds invest in futures, options and/or swaps, for certain filings with the CFTC.
- 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.
- For hedge funds that acquire non-US investments, certain foreign filings may be required.

In addition, the SEC has adopted substantial new reporting obligations with respect to hedge funds under Form PF. Form PF imposes filing obligations on registered advisers with at least US\$150 million private fund assets under management, as follows:

- "Large" hedge fund advisers (advisers managing hedge funds (including certain separately managed accounts) that collectively have at least US\$1.5 billion in assets under management) must file Form PF on a quarterly basis.
- Other hedge fund advisers managing less than US\$1.5 billion hedge fund assets under management must file annually (and are subject to less comprehensive disclosure requirements).

- Form PF requires 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 a narrow subset of the Form PF disclosures 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.

24. 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 28*). 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 Advisers Act requirements including those relating to custody, advertising, personal trading, record keeping and proxy voting.

Advisers not subject to registration under the Advisers Act may still be subject to state registration requirements. Advisers to funds engaging in futures, options and/or swaps 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 Advisers Act if all of the following apply:

- 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

25. 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. 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

In a parallel fund structure, 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.

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.

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

Tax treatment

26. 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.
- A US withholding tax on a broad range of US-source withholdable payments under FATCA. This will generally not apply if the fund enters into a withholding/reporting agreement with the US Treasury or complies with an applicable intergovernmental agreement.

Resident investors

For an entity 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.

Investments by US taxable investors in offshore entities treated for US tax purposes as corporations are 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

27. 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 (typically, 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

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

In 2013, US financial regulators issued final regulations implementing the Volcker Rule, which, subject to certain exceptions, prohibits proprietary trading and the investment in, and sponsorship of, private funds, including most hedge funds, by banking entities and their affiliates that are subject to regulation under the US Bank Holding Company Act of 1956, as amended. To comply with the law, entities subject to the Volcker Rule strictures are evaluating their compliance requirements and may seek to redeem, transfer, or restructure their ownership interests in hedge funds. Full compliance with the Volcker Rule regulations is required by 21 July 2015, although the effective date for compliance with the portion of the Volcker Rule relating to banks' unwinding of their ownership interests in "legacy" funds has been extended to 21 July 2017.

In addition, the SEC has been focused on cybersecurity and recently issued guidance on measures investment advisers should consider in addressing cybersecurity risk.

Practical Law Contributor profiles



Bryan Chegwidden, Partner

Ropes & Gray LLP

T +1 212 497 3636

F +1 646 728 1576

E bryan.chegwidden@ropesgray.com

W www.ropesgray.com



James Thomas, Partner

Ropes & Gray LLP

T +1 617 951 7367

F +1 617 235 0483

E james.thomas@ropesgray.com

W www.ropesgray.com

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*, 2013.
- Co-author, Investment funds: United States, *Practical Law Investment Funds Multi-jurisdictional Guide*, 2012.

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*, 2013.
- Co-author, Investment funds: United States, *Practical Law Investment Funds Multi-jurisdictional Guide*, 2012.

**Sarah Davidoff, Partner**

Ropes & Gray LLP

T +1 212 596 9017**F** +1 646 728 6225**E** sarah.davidoff@ropesgray.com**W** www.ropesgray.com

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, Investment funds: United States, *Practical Law Investment Funds Multi-jurisdictional Guide*, 2013.
- Co-author, Investment funds: United States, *Practical Law Investment Funds Multi-jurisdictional Guide*, 2012.
- Co-author, US Chapter: Investment Funds Jurisdictional Comparisons, *The European Lawyer Reference*, 2012.