Fund Management

2018

GETTING THE DEAL THROUGH

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Fund Management 2018

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Fourth edition

Getting the Deal Through is delighted to publish the fourth edition of *Fund Management*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Hong Kong and Luxembourg.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise.

GETTING THE DEAL THROUGH

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United States

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K&L Gates LLP

Fund management

1 How is fund management regulated in your jurisdiction? Which authorities have primary responsibility for regulating funds, fund managers and those marketing funds?

The US Securities and Exchange Commission (SEC) is the regulatory authority primarily responsible for oversight of fund management and offering activities in the US. The substantive regulation is as follows:

- the US Investment Company Act of 1940, as amended (the 1940 Act), which governs the structure and operation of funds (or 'investment companies' as they are referred to under US law);
- the US Securities Act of 1933, as amended (the 1933 Act), which governs the offer and sale of securities, including fund interests;
- the US Investment Advisers Act of 1940, as amended (the Advisers Act), which governs the activities of fund sponsors and portfolio managers; and
- the US Securities Exchange Act of 1934, as amended (the Exchange Act), which governs the marketing and sale of fund interests by broker-dealers.

Registered and private funds

Investment companies that are marketed and sold to the general public must be registered under the 1940 Act (registered funds). Registered funds can be open-ended or closed-ended and diversified or non-diversified. Private funds are excepted from the definition of investment company and are not registered or regulated under the 1940 Act, save for certain limitations when investing in registered funds.

Shares of registered funds are typically offered to the public and registered under the 1933 Act. In contrast, private funds issue securities in private offerings that are exempt from registration under the 1933 Act, although they will typically seek to adhere to an offering regime promulgated under the 1933 Act that provides a safe harbour from registration. It is also possible for a fund to be registered as an investment company under the 1940 Act, but not conduct a public offering. In this case, similar to a private fund, the registered fund would offer its shares pursuant to an exemption from registration under the 1933 Act.

Fund managers (investment advisers)

Investment advisers with a principal place of business in the US generally must register with the SEC or with the state securities agency for the state of their principal place of business. Generally, investment advisers with at least US$100 million of assets under management must register with the SEC, and smaller advisers must register at the state level. Absent an exemption, non-US advisers that provide investment advisory services in the US must also register with the SEC. Registration with the SEC or a state securities agency requires the filing of Form ADV. Among other things, Form ADV requests information about an adviser's business, services, strategies, and the attendant conflicts of interest and risks to clients of the adviser.

Marketers

The marketing of registered and private funds is generally conducted by broker-dealers registered under the Exchange Act. The SEC is primarily responsible for oversight of broker-dealers, but broker-dealers must also become members of the Financial Industry Regulatory Authority (FINRA), a self-regulatory organisation. For an in-depth discussion of marketers, see question 7 (marketing generally), question 15 (marketing of registered funds) and question 26 (marketing of private funds).

Other regulators

The US Commodity Futures Trading Commission (CFTC) is the regulatory authority responsible for the regulation of commodity trading. Fund managers that invest in commodities on behalf of clients, including registered funds, may be required to register with the CFTC and become members of the National Futures Association, or seek an exemption from registration. Many fund managers are subject to regulation by both the SEC and the CFTC because they trade both securities and commodities.

The US Employee Retirement Income Security Act of 1974, as amended (ERISA), applies to most employee retirement and welfare benefit plans maintained by private corporate employers, and by extension to the management of assets for such plans. Regulations under ERISA are issued by the US Department of Labor. Under ERISA and related regulations, if plan investors in the aggregate hold 25 per cent or more of the value of any class of equity interests in a private fund, the fund's assets will be treated as 'plan assets'. In such case, the fund manager will be subject to a heightened fiduciary standard under ERISA, including certain express prohibitions imposed on fiduciaries by ERISA.

2 Is fund administration regulated in your jurisdiction?

Fund administration activities such as accounting, financial reporting and performance-related services are generally not subject to regulation in the US. Often, funds outsource these activities to third-party administrators.

3 What is the authorisation or licensing process for funds? What are the key requirements that apply to managers and operators of investment funds in your jurisdiction?

To register as an investment company, an issuer must file a registration statement with the SEC that contains the fund's prospectus as well as certain additional disclosure documents and other information regarding the issuing fund. The registration statement is subject to review and comment by SEC staff. Registered open-ended funds may, and typically do, offer several classes of shares, certain expenses of which may vary. Registered closed-ended funds may not offer multiple share classes, except pursuant to an exemptive order granted by the SEC.

Investment advisers registered under the Advisers Act are deemed to be fiduciaries and are subject to an anti-fraud regime that imposes several obligations and restrictions with respect to, among other things:

- best execution and trading practices;
- advertising and marketing;
- proxy voting;
- performance-based fees;
- solicitation arrangements;
- political contributions;
- record-keeping; and
- custody of client assets.

Advisers are subject to periodic SEC examinations and must adopt written compliance policies and procedures designed to detect and prevent violations of the Advisers Act.

4 What is the territorial scope of fund regulation? Can an overseas manager perform management activities or provide services to clients in your jurisdiction without authorisation?

In general, an investment adviser that provides advice to US clients must comply with US regulation, regardless of whether its principal place of business is located in the US or abroad. However, certain exemptions and other arrangements can limit the application of US regulation to investment advisers with a principal place of business outside the US (non-US advisers).

Foreign private adviser exemption

A non-US adviser is exempt from the obligation to register with the SEC if it:

- has no place of business in the US from which it provides actual investment advice;
- has in the aggregate fewer than 15 clients and investors in the US in private funds it advises;
- manages less than US$25 million attributable to US clients and investors; and
- does not hold itself out to the US public as an investment adviser.

Private fund adviser exemption

A non-US adviser may be deemed an 'exempt reporting adviser', exempt from registration under the Advisers Act, if:

- it provides investment advisory services only to one or more qualifying private funds; and
- the aggregate assets managed by the adviser at a place of business in the US are less than US$150 million.

Exempt reporting advisers are subject to limited SEC reporting and other requirements; this exemption is sometimes referred to colloquially as 'registration lite'.

Participating affiliate arrangement

A non-US adviser that is an affiliate of an SEC-registered adviser (participating affiliate) may provide investment advice to US clients subject to certain conditions, including:

- the registered adviser and participating affiliate are separate legal entities;
- the participating affiliate appoints a US agent for service of process and submits to US jurisdiction;
- personnel of the participating affiliate that provide advisory services to US clients or who have access to certain information regarding US persons are treated as associated persons of the registered adviser; and
- the participating affiliate maintains certain records required by the Advisers Act.

In a participating affiliate arrangement, the participating affiliate is not required to register with the SEC, but its activities on behalf of US clients are subject to the substantive requirements of the Advisers Act.

5 Is the acquisition of a controlling or non-controlling stake in a fund manager in your jurisdiction subject to prior authorisation by the regulator?

The acquisition of a controlling stake in an investment adviser is not subject to prior authorisation by the SEC or any other US regulatory authority. However, the acquisition of a controlling stake in an investment adviser may be considered an assignment of the adviser's contracts with clients, which requires client consent. Where the investment adviser is an adviser to a registered fund, such an assignment automatically terminates the existing advisory agreement between the adviser and the fund, typically resulting in the need to obtain a majority approval of the fund's shareholders for a new contract. For these purposes, a 25 per cent ownership stake is presumed to confer 'control' of an investment adviser, but certain circumstances, such as mergers among affiliates, fall outside these requirements.

6 Are there any regulatory restrictions on the structuring of the fund manager's compensation and profit-sharing arrangements?

There are no regulatory restrictions on the structuring of an adviser's asset-based management fee. However, the Advisers Act restricts an investment adviser from receiving compensation based on a share of realised or unrealised capital appreciation (ie, a performance-based fee) unless the fee is charged to a 'qualified client', which includes a natural person or institution with a net worth of at least US$2.1 million or with at least US$1 million in assets under the adviser's management; or a 'fulcrum fee' that increases and decreases proportionately with the investment performance of a managed fund.

Fund marketing

7 Does the marketing of investment funds in your jurisdiction require authorisation?

A person engaged in the business of marketing securities in the US, including fund interests, is generally subject to regulation as a broker-dealer. A limited exemption exists for certain associated persons of a fund's sponsor who do not receive commissions or transaction-based compensation, are not associated persons of a broker-dealer and who perform substantial duties other than offering the fund's shares. Many fund sponsors avoid broker-dealer registration requirements by engaging an affiliated or third-party broker-dealer to solicit investments by potential investors.

8 What marketing activities require authorisation?

Generally, the receipt of transaction-based compensation in connection with a securities transaction, including compensation based on the outcome or size of the transaction, is considered the hallmark of broker-dealer activity that would require registration. However, participation in the solicitation, negotiation or execution of a securities transaction may also require registration, depending on the facts and circumstances.

In addition, marketing materials are subject to differing regulatory regimes. Advertisements of investment advisers are subject to rules and guidance under the Advisers Act. Advertisements disseminated by a broker-dealer are subject to FINRA rules. The CFTC also regulates advertisements for commodity pool operators.

9 What is the territorial scope of your regulation? May an overseas entity perform fund marketing activities in your jurisdiction without authorisation?

All broker-dealers conducting activities in the US, even if their activities are directed only to investors outside the US, must register in the US. Conversely, a non-US broker-dealer that induces or attempts to induce securities transactions by any person in the US must register in the US or work with a US broker-dealer to chaperone their activities.

10 If a local entity must be involved in the fund marketing process, how is this rule satisfied in practice?

Many fund managers engage a US broker-dealer to market their funds. The US broker-dealer acts as the placement agent for the securities of the fund and representatives of the broker-dealer accompany fund manager personnel at meetings with potential investors.

11 What restrictions are there on intermediaries earning commission payments in relation to their marketing activities in your jurisdiction?

When selling registered fund shares, broker-dealers are subject to a FINRA rule that imposes caps on a broker-dealer's sales compensation and distribution fee levels. The amount of sales compensation that will be deemed excessive, and therefore in violation of the rule, is dependent on whether the fund has an asset-based sales charge or is a fund of funds.

Retail funds

12 What are the main legal vehicles used to set up a retail fund? How are they formed?

US law does not require registered funds to be organised using a particular corporate form. Various legal forms may be used, although in practice registered funds are typically organised under state law as Massachusetts business trusts, Delaware statutory trusts or Maryland corporations. In addition, the 1940 Act requires registered funds to establish a board of directors or trustees (the board).

13 What are the key laws and other sets of rules that govern retail funds?

The 1940 Act and the 1933 Act, and the rules thereunder, primarily govern registered funds and the public offering of their securities. In addition, the SEC has issued no-action letter guidance and interpretive statements and publications clarifying the application of these laws and rules. Investment advisers to registered funds are subject to the Advisers Act and the rules and guidance thereunder.

Registered exchange-listed closed-ended funds and open-ended exchange-traded funds (ETFs) are also subject to the listing and trading rules of the relevant exchange.

14 Must retail funds be authorised or licensed to be established or marketed in your jurisdiction?

Registered funds must be registered under the 1940 Act. To market or sell their securities in a public offering, registered funds must also register their securities under the 1933 Act and comply with the attendant requirements.

15 Who can market retail funds? To whom can they be marketed?

Registered funds are principally marketed by broker-dealers, although banks and insurance companies may also distribute registered fund shares.

Shares of registered open-ended funds (except ETFs) may be offered and sold to any investor. Registered closed-ended funds listed on an exchange are typically offered to investors via an initial public offering where broker-dealers act as underwriters to the publicly offered shares.

ETF shares are only sold to certain broker-dealers that are 'authorised participants' in large blocks known as 'creation units.' The authorised participants then sell individual ETF shares on an exchange.

16 Are there any special requirements that apply to managers or operators of retail funds?

An investment adviser to a registered fund generally must be an investment adviser registered with the SEC under the Advisers Act. A registered fund, and in practice its investment adviser, must also maintain policies and procedures to comply with the 1940 Act, including a code of ethics. In addition, a registered fund must have a written investment advisory agreement with an investment adviser, and the agreement must be approved at least annually by the fund's board.

17 What are the investment and borrowing restrictions on retail funds?

Fundamental investment policies

A registered fund's registration statement must recite the fund's fundamental investment policies with respect to certain types of investments and investment practices, and the fund cannot deviate from these policies without a shareholder vote. Fundamental investment policies include:

- diversification (ie, whether a registered fund will operate as a diversified or non-diversified fund);
- concentration in a particular industry or group of industries;
- policies around borrowing money and the issuance of senior securities;
- underwriting;
- making loans; and
- investing in commodities or real estate.

To be considered 'diversified', at least 75 per cent of a registered fund's total assets must be represented by cash, government securities, securities of other investment companies and securities of other issuers, subject to certain additional restrictions.

Non-fundamental investment policies

In addition to fundamental investment policies, a registered fund may adopt non-fundamental investment limitations, which may be changed by the fund's board without shareholder approval. Common non-fundamental investment policies include 'names rule' policies and policies regarding a registered fund's investments in illiquid securities (as described below).

Names rule policy

Under the 1940 Act, a registered fund that has a name suggesting that the fund focuses its investments in a particular type of investment or in a particular industry must adopt a policy to invest, under normal circumstances, at least 80 per cent of the value of its assets in the particular type of investments suggested by the fund's name. Likewise, if a registered fund's name suggests that the fund focuses its investments in a particular country or geographic region, at least 80 per cent of the value of its assets must be invested in assets that are tied economically to the particular country or geographic region.

Illiquid securities

According to SEC staff guidance, a registered open-ended fund may invest no more than 15 per cent of its assets in illiquid securities. Many registered funds have adopted non-fundamental investment policies in order to comply with this guidance. In 2016, the SEC adopted a new Liquidity Rule, which codifies the 15 per cent limit on illiquid investments and requires registered funds (including ETFs, but excluding money market and registered closed-ended funds) to establish and implement written liquidity risk management programmes (see 'Update and trends').

Borrowing

A registered open-ended fund may borrow money, provided that the borrowing is from a bank and the fund has asset coverage at least equal to 300 per cent of such borrowings. A registered closed-ended fund may borrow money from a bank or from a private source, and must also meet the asset coverage limitation of 300 per cent. A registered closed-ended fund may also issue preferred shares, subject to a 200 per cent asset coverage limitation.

Certain financing and derivative transactions such as reverse repurchase agreements, short sales, options, forwards and futures, can create economic and legal exposure that are similar in some respects to the issuance of senior securities. To address this concern, the SEC and its staff have generally taken the position that these transactions will not be subject to the limitations on borrowing and issuing senior securities if a registered fund segregates liquid assets sufficient to meet its future obligations arising from such transactions.

18 What is the tax treatment of retail funds? Are exemptions available?

The tax treatment of registered funds is governed by the Internal Revenue Code (IRC). Under the IRC, registered funds receive pass-through tax treatment, meaning that the fund itself is not subject to federal income tax, but rather that income and capital gains are passed through to the fund's investors. To qualify as a regulated investment company, and therefore receive pass-through tax treatment, a fund must meet certain eligibility requirements.

19 Must the portfolio of assets of a retail fund be held by a separate local custodian? What regulations are in place to protect the fund's assets?

The assets of a registered fund must be held by a 'qualified custodian' under conditions designed to assure the safety of the fund's assets. Assets may also be posted to a futures commission merchant to support trading futures and swaps, or held by a foreign custodian that segregates fund assets from its proprietary assets.

20 What are the main governance requirements for a retail fund formed in your jurisdiction?

All registered funds must establish a board of directors or trustees. At least 40 per cent of the board members must be independent; however, to take advantage of many exemptive rules under the 1940 Act, a majority of the board's members must be independent. The board retains overall responsibility for the operation of the fund, which specifically includes the review and approval of the fund's advisory contract or contracts, underwriting agreements, distribution plans and related agreements, the selection of the fund's independent auditors and oversight of potential risks and conflicts faced by the fund. Although the board is not involved in the day-to-day management of the fund, it is also responsible for approving the fund's compliance policies and procedures.

All registered funds must designate an individual as chief compliance officer (CCO). The CCO is tasked with administering the fund's compliance policies and procedures and must have sufficient authority to compel others to adhere to them. The CCO reviews the adequacy and application of the compliance policies and procedures, and provides an annual written report to the fund's board.

21 What are the periodic reporting requirements for retail funds?

Registered funds must maintain registration statements with the SEC, and are also required to file periodic reports including annual and semi-annual shareholder reports with the following detailed financial information:

- Form N-CSR: disclosure of a fund's complete portfolio holdings required within 10 days of delivery of any semi-annual or annual shareholder report;
- Form N-PX: annual disclosure of the proxy record for all portfolio securities; and
- Form N-MFP: monthly disclosure of portfolio holdings and other information required for money market funds.

In 2016, the SEC imposed extensive new disclosure and reporting obligations for most registered funds. In addition to amending existing forms, the SEC adopted three new forms:

- Form N-PORT: portfolio-wide and position-level disclosure of holdings data filed monthly;
- Form N-CEN: census-type disclosure filed annually; and
- Form N-LIQUID: confidential disclosures required by the Liquidity Rule upon certain triggering events.

22 Can the manager or operator place any restrictions on the issue, transfer and redemption of interests in retail funds?

Registered open-ended funds (except ETFs) may set minimum investment requirements. Minimum investment requirements are typically related to the type of investor the fund intends a share class to be sold to (eg, shares with a higher minimum typically will be marketed or sold to high net worth individuals or institutional investors). Although a share class may have a distinct investment minimum and certain expenses may vary by share class, all share classes of a fund must charge the same advisory fee. In addition, a registered fund's board may adopt a policy of not selling shares to certain investors whose ownership in the fund may be disruptive to the fund's operations (eg, market timers that exploit pricing inefficiencies).

A registered fund generally must pay redemption proceeds to a shareholder within seven days of receiving the redemption request. Exceptions exist in certain instances (eg, when the SEC issues an order delaying redemptions to protect shareholders in the fund). Registered funds are permitted to charge a redemption fee when shareholders redeem; however, the SEC has limited the fee to 2 per cent.

Registered closed-ended funds do not issue redeemable securities.

Non-retail pooled funds

23 What are the main legal vehicles used to set up a non-retail fund? How are they formed?

Most funds that are excluded from regulation under the 1940 Act are referred to as 'private funds' regardless of the investment strategy pursued by the fund. Private funds may be organised in various forms, including as limited partnerships, limited liability companies (LLCs) and statutory trusts. Private funds can also be organised in non-US jurisdictions. The most common jurisdictions are Delaware for domestic funds and the Cayman Islands for offshore funds.

Most domestic funds are organised as Delaware limited partnerships, which have a general partner (GP) or sponsor that is responsible for the management of the private fund, while the limited partners (LPs) are passive investors. Typically, the GP delegates management responsibility to an investment adviser via an investment management agreement (IMA).

Delaware limited partnerships are formed under the Delaware Revised Uniform Limited Partnership Act by filing a certificate of limited partnership signed by the GP. The limited partnership agreement (LPA), the IMA and other organisational documents are not publicly filed. A Delaware limited partnership must maintain a registered agent and office in Delaware; however, most limited partnerships hire a service provider to satisfy this requirement. LLCs are substantially similar to limited partnerships, but receive different tax treatment in certain jurisdictions.

24 What are the key laws and other sets of rules that govern non-retail funds?

Many of the key rules that govern the activities of private funds relate to the perfection and maintenance of their exceptions from US federal securities laws and the obligations they impose on registered funds.

Private funds rely on exceptions from the registration provisions of the 1940 Act, most commonly section 3(c)(1) and section 3(c)(7). Section 3(c)(1) is an exception available to a fund with 100 or fewer investors, and section 3(c)(7) is an exception available to a fund offered only to 'qualified purchasers' (generally, natural persons with US$5 million in investments or institutions with US$25 million in investments). To rely on these exceptions, private funds must also avoid conducting a public offering and registering the sale of their securities under the 1933 Act.

The SEC has promulgated a set of rules under the 1933 Act, collectively designated Regulation D, that provide a safe harbour for private offerings. Regulation D generally requires that a private offering be directed exclusively to 'accredited investors', although non-accredited investors may be admitted under certain circumstances. Historically, private funds could not use general solicitation or general advertising, including offerings made via the radio, newspaper or any other public medium. However, the SEC has recently allowed for the use of general solicitation, subject to certain conditions, including enhanced requirements to ensure that sales are made only to accredited investors.

There are eight categories of accredited investors, although, in practice, most investors typically fall under one of the following:

- an individual with a net worth (or joint net worth with spouse) in excess of US$1 million, excluding the value of their primary residence;
- an individual with income in excess of US$200,000 (or US$300,000 joint income with spouse) in each of the previous two years and who reasonably expects to have income in excess of US$200,000 (or joint income in excess of US$300,000) in the current year; and
- a corporation, partnership or LLC with assets in excess of US$5 million that was not formed for the specific purpose of acquiring the securities offered.

Private funds structured as limited partnerships are governed by an LPA, which provides a framework for the operations and structure of the limited partnership, and grants the GP authority to enter into agreements on behalf of the LPs. A private fund's principal offering document is its private placement memorandum, which provides investors with information regarding the fund.

Private funds are excepted from the governance and other restrictions of the 1940 Act; consequently sponsors enjoy extraordinary latitude in structuring the operations of the fund. However, managers of private funds (other than certain private funds that invest in real estate) are investment advisers. All investment advisers operating in the US (regardless of registration status) are fiduciaries to their clients and are, among other things, subject to anti-fraud provisions of federal and state law.

25 Must non-retail funds be authorised or licensed to be established or marketed in your jurisdiction?

No. Private funds are not subject to authorisation or licensing requirements in the US, although funds that seek to rely on the safe harbour provisions of Regulation D discussed above must make a brief notice filing known as Form D.

26 Who can market non-retail funds? To whom can they be marketed?

As described in question 7, a person engaged in the business of marketing a private fund in the US is generally subject to registration as a broker-dealer, although a limited 'issuer exemption' may be available to personnel of the sponsor. Private funds are generally marketed only to accredited investors or qualified purchasers, as described in question 24.

Update and trends

Cybersecurity
In its 2018 examination priorities, the SEC staff indicated that its examinations would continue to focus on cybersecurity issues, including with respect to governance and risk assessment, access rights and controls, data loss prevention, vendor management, training and incident response. The SEC staff also stated that it would seek to keep pace with advancing technology in order to monitor for cybersecurity risks, engage with the industry in efforts to help combat cybersecurity attacks and prevent investor harm.

Liquidity Rule
As discussed in question 17, the SEC recently adopted the Liquidity Rule, which requires registered funds (other than registered closed-ended funds) to, among other things, establish a liquidity risk management programme. The compliance dates for the provisions of the rule have recently been in flux. As of 22 February 2018, the compliance dates for the classification, highly liquid investment minimum, board approval and related reporting requirements on Form N-LIQUID and liquidity disclosures on Form N-PORT are expected to be 1 June 2019 for larger entities and 1 December 2019 for smaller entities. For all other provisions of the rule, the compliance dates are 1 December 2018 for larger entities and 1 June 2019 for smaller entities.

Cryptocurrency and initial coin offerings (ICOs)
In December 2017, the chairman of the SEC released a statement on the recent growth of ICOs and the potential for regulation of tokens offered in ICOs as securities under US securities laws. The SEC simultaneously filed an Order against a cryptocurrency issuer concluding that the issuance of a particular token constituted an unregistered offering of securities. Amid regulatory uncertainty, the SEC is expected to continue to give careful consideration to certain disclosures and whether any given ICO is subject to US securities laws.

Qualified Financial Contracts Rule
New rules set to be phased-in starting on 1 January 2019 will require certain US banks to include terms in a range of financial contracts that will delay or restrict a fund's termination and other rights in the event that the bank or one or more of its affiliates become subject to insolvency proceedings. The implementation of these rules by regulated banks could limit a fund's ability to exercise cross-default rights and may cause funds to reconsider the risks presented by the use of certain derivative instruments.

Fiduciary Rule reform and Regulation Best Interest
As discussed in question 36, the SEC has proposed new rules and interpretations related to investment advisers' and broker-dealers' relationships with their retail customers. The regulatory package is designed to enhance transparency by, among other things, requiring investment advisers and broker-dealers to provide certain disclosures, exercise due care and address conflicts of interest arising from the relationships and services provided.

27 Do investor-protection rules restrict ownership in non-retail funds to certain classes of investor?

The private offering exemption and rules discussed in questions 24 and 26 effectively restrict private funds from offering securities to investors without a minimum threshold of assets or income.

28 Are there any special requirements that apply to managers or operators of non-retail funds?

Generally no, except that if a private fund is considered to be 'plan assets', the manager of the fund generally must comply with certain ERISA requirements. The requirements of ERISA and when a fund's assets will be treated as plan assets are discussed in question 1.

29 What is the tax treatment of non-retail funds? Are any exemptions available?

Like registered funds, most private funds organised as LPs or LLCs receive pass-through tax treatment under the IRC, meaning that the fund itself is not subject to federal income tax, but rather income and capital gains are passed through to the fund's investors. See question 39 for a discussion of tax withholding rules applicable to foreign investors in private funds.

30 Must the portfolio of assets of a non-retail fund be held by a separate local custodian? What regulations are in place to protect the fund's assets?

The assets of a private fund do not need to be held by a separate local custodian; however, in order to comply with the 'custody rule' under the Advisers Act, a fund manager that is a registered investment adviser will generally maintain the assets of a private fund with a qualified custodian, and, among other things, will distribute the fund's audited financial statements to investors within 120 days of the fund's fiscal year end.

31 What are the main governance requirements for a non-retail fund formed in your jurisdiction?

The private fund's GP has broad authority over the operations of the fund, subject to any limitations provided in the LPA. Unlike registered funds, US private funds are not required to have a board of directors or trustees; however, under state law and the Advisers Act, the GP owes certain fiduciary duties to each LP. Many LPAs of private equity and real estate private funds will establish an 'advisory committee' of LPs that can receive disclosure or consent to conflicts of interest, or both, that arise during the life of the fund.

32 What are the periodic reporting requirements for non-retail funds?

Registered investment advisers must identify the private funds they manage on Form ADV, and must disclose certain information about the private fund, including the types, size, leverage, liquidity, and the types of investors, on Form ADV or Form PF, or both. Form PF is required for all registered investment advisers with at least US$150 million in private fund assets under management. A private fund's LPA will also typically provide for certain reports to be provided to the LPs, including financial statements, performance reports and annual tax reports.

Separately managed accounts

33 How are separately managed accounts typically structured in your jurisdiction?

Separately managed accounts (SMAs) are typically managed by a registered investment adviser. The adviser will typically enter into an investment management agreement with a client that grants the adviser authority to manage the client's assets in accordance with a designated investment strategy. Institutional investors in the US typically hire a separate custodian to hold assets and assist with the administration of the account, and will hire an investment adviser directly. Retail SMAs are frequently sponsored by a broker-dealer that is responsible for the operations, custody and administration of the account and for engaging an investment adviser on behalf of account holders.

34 What are the key legal issues to be determined when structuring a separately managed account?

An investment management agreement for an SMA should define the investment strategy to be employed by the investment adviser and identify any investment policies and restrictions that must be observed by the investment adviser when managing the account. In addition, the agreement generally should address, among other things, the following topics:

- appointment (and acceptance) of investment manager as investment adviser to the client;
- delineation of voting responsibilities between adviser and client with respect to corporate actions, proxy voting and class actions;
- authorisation to select trading counterparties, generate research from brokerage and 'block' trades, as applicable;
- delivery of Form ADV to the client;
- calculation of management fees and time frame for payment;
- indemnification and liability standard;
- ERISA obligations (if the SMA client is a benefit plan investor); and

- 'assignment provision': the Advisers Act prohibits the assignment of an advisory agreement by the adviser without client consent. The assignment provision should define the term 'assignment' within the meaning under the Advisers Act and allow flexibility for negative consent.

Additional issues arise in the context of 'wrap fee' programmes, which charge investors a bundled fee, based on a percentage of assets, for investment advice and brokerage through a 'sponsor' of the programme. For example, advisers that provide discretionary advice to multiple clients using a similar strategy must be cautious to avoid the creation of an unregistered investment company.

An adviser must also be cognisant of its fiduciary duties to clients, including the obligation to disclose all material conflicts of interests. An adviser also owes a duty to seek best execution for securities transactions. 'Soft dollar' arrangements are permitted under US law, subject to certain conditions, including that the adviser makes a good faith determination that trading commissions borne by clients are reasonable in relation to the value of products and services received by the adviser from trading counterparties.

35 Is the management or marketing of separately managed accounts regulated in your jurisdiction?

Investment advisers owe the same fiduciary duties to fund clients and SMA clients, but the marketing of SMA strategies is governed by the Advisers Act, rather than the Exchange Act and FINRA rules. An SEC advertising rule expands on the anti-fraud provisions of the Advisers Act, and an intricate disclosure regime, particularly with respect to the presentation of investment performance, has developed over several decades of guidance from SEC staff and enforcement actions. Certain record-keeping obligations also apply with respect to materials that include performance.

In addition, many institutional managers choose to comply with CFA Institute's Global Investment Performance Standards (GIPS). GIPS are voluntary, ethical principles for the reporting of investment performance results and are designed to facilitate apples-to-apples comparison of investment performance. While the SEC does not formally endorse GIPS compliance, it will bring enforcement actions against firms that claim GIPS compliance, but do not adhere to the Standards.

General

36 Are there proposals for further regulation of funds, fund managers or marketers of funds in your jurisdiction?

In October 2017, the US Department of the Treasury (the Treasury) released a report summarising and providing recommendations regarding certain regulations governing the US financial system, including regulations governing the US fund management industry. Although the SEC is not required to act on these recommendations, the Treasury suggested that the SEC consider, among other things, rules to simplify the creation of ETFs, modernisation of shareholder reporting and rules aimed at promoting the creation of registered closed-ended funds that invest in smaller public companies and private companies. In addition, the Treasury report recommended that the SEC and the CFTC work to limit the cross-border application of contradictory rules by harmonising their regulations with the rules of non-US jurisdictions.

In April 2018, the SEC proposed a package of new rules and interpretations designed to define and describe retail investors' relationships with investment advisers and broker-dealers. First, under a new proposed rule called Regulation Best Interest, a broker-dealer would be required to act in the best interests of a retail customer when making a recommendation of any securities transaction or investment strategy involving securities to a retail customer. Regulation Best Interest is designed to make it clear that a broker-dealer may not put its financial interests ahead of the interests of a retail customer in making recommendations. This 'best interest' duty would be satisfied if, among other things, the broker-dealer:

- discloses to the retail customer the material facts relating to the scope and terms of the relationship, including any material conflicts of interest;
- exercises reasonable diligence, care, skill and prudence when making a recommendation; and
- establishes and maintains written policies and procedures designed to identify, disclose and eliminate material conflicts of interest associated with the recommendation.

Second, the SEC proposed new and amended rules that would require investment advisers and broker-dealers to provide to retail investors a customer or client relationship summary. Form CRS would provide retail investors with a brief summary regarding their relationship to their investment adviser or broker-dealer and would, among other things, disclose the fees and expenses associated with the services provided and their standard of conduct and would supplement other more detailed disclosures. Finally, the SEC also proposed an interpretation seeking to reaffirm, and in some cases clarify, aspects of the fiduciary duty that investment advisers currently owe to their clients under existing laws and regulations. The SEC is seeking public comments on these new rule proposals and interpretations until 7 August 2018.

37 Outline any specific requirements for stock-exchange listing of retail and non-retail funds.

Registered closed-ended funds and ETFs are the only type of registered funds listed on an exchange. Private funds are not listed on an exchange.

Each exchange imposes various requirements for the listing of fund shares. The New York Stock Exchange, for example, requires certain corporate governance measures (ie, the fund must have an independent audit committee), annual shareholder meetings and reporting with respect to holdings of fund shares by certain insiders. Additionally, an annual certification is provided to the exchange to indicate compliance with the listing requirements.

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38 Is it possible to redomicile an overseas vehicle in your jurisdiction?

It is possible to redomicile an overseas vehicle in the US, although the process will vary depending on state law in the chosen state of incorporation.

39 Are there any special rules relating to the ability of foreign investors to invest in funds established or managed in your jurisdiction or domestic investors to invest in funds established or managed abroad?

Foreign investors generally may invest in US-registered or private funds without limitation, although certain income paid by such funds to the foreign investors may be subject to US withholding tax of 30 per cent (or at a lower rate under an applicable tax treaty). There are exemptions from such US withholding tax, including for certain items of capital gain and interest income earned through a private fund, as well as for registered fund distributions of net capital gains, net short-term capital gain dividends and interest-related dividends. The withholding tax will apply to other registered fund dividends and on US corporate dividends. Foreign investors may also be subject to regular US income tax on certain types of business income earned through private funds and on gains from investments related to US real property.

US investors may invest in foreign private funds or another country's registered fund equivalent, which may subject the investor to foreign tax withholding. In addition, there may be adverse US income tax treatment for a US taxable investor who invests in certain foreign private funds and registered fund equivalents that are not treated as pass-through entities for purposes of US tax law under the passive foreign investment company rules.

Getting the Deal Through

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Private Banking & Wealth Management
Private Client
Private Equity
Private M&A
Product Liability
Product Recall
Project Finance
Public M&A
Public-Private Partnerships
Public Procurement
Real Estate
Real Estate M&A
Renewable Energy
Restructuring & Insolvency
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