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Investment Funds

USA

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Law and Practice

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Contents

Sidley Austin LLP has a premier, global practice in structuring and advising investment funds and advisers. The investment funds practice group serves virtually every type of investment fund and investment manager, as well as banks, broker-dealers, corporations and clearing firms. The group has approximately 130 lawyers dedicated to investment funds, investment management and derivatives work worldwide, who practise in New York, Chicago, Boston, Los Angeles, San Francisco, London, Munich, Hong Kong, Singapore, Shanghai and Tokyo. The firm has substantial experience in organising and advising with respect to funds registered under the Investment Company Act of 1940, hedge funds, commodity pools, exchange-traded funds (ETFs), private equity and venture capital funds, real estate funds and REITs, hedge fund and private equity funds of funds, business development companies and employees' securities companies. Sidley's practice brings it into frequent contact with the departments of government, regulatory agencies and exchanges that supervise the securities and derivatives markets.

Authors

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Jesse C Kean is a partner who has worked on a wide range of corporate and securities transactions. He has extensive experience in matters related to the Investment Company Act of 1940 and has worked on a variety of transactions for open-end and closed-end investment companies, including complex fund mergers. His experience includes the launch and ongoing representation of global, emerging market and US-focused funds with a variety of market capitalisations, as well as liquid alternative funds, multi-asset funds, index funds, target date funds, money market funds, ETFs, sector-specific funds, smart beta funds and credit funds, certain of which use unique strategies, derivatives and offshore subsidiaries. Jesse is a member of the American Bar Association, the New York City Bar Association and the Federal Bar Association, with a Juris Doctor degree from the Fordham University School of Law.

Daniel F Spies is a partner with over 15 years' experience of focusing on securities and futures-related investment funds and corporate transactions, including related regulatory matters. He regularly advises clients on the formation of hedge funds, private equity funds, hybrid funds, commodity pools, funds of funds, managed accounts and single-investor funds. Dan also assists clients with the formation and operation of their management entities, including compliance with the Investment Advisers Act and the Commodity Exchange Act. He has a particular focus on seed capital arrangements, including seed capital funds and seeding transactions, representing seeders and recipients of seed funding. Dan, who has a Juris Doctor degree from the University of Michigan Law School (cum laude), has also advised several clients in connection with manager acquisitions.

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1. Fund Formation

1.1 Formation of Investment Funds

Private Equity, Hedge Fund

Sponsors and managers commonly use the US as the jurisdiction for the formation of private equity and hedge funds, particularly for funds which are intended to attract investments from US investors and make investments in US targets. Delaware is the preferred jurisdiction for most US PE funds and hedge funds because the two laws that typically control fund entities, the Delaware Revised Uniform Limited Partnership Act, as amended, and the Delaware Limited Liability Company Act, as amended, explicitly provide that their intention is to allow the intent of the parties as evidenced in the governing fund agreements to govern to the greatest extent possible. These funds are typically organised as pass-through entities for US federal income tax purposes.

Registered Investment Company

The US is a jurisdiction frequently used for the formation of registered investment companies. Common types are open-end funds, including exchange-traded funds and money market funds, and closed-end funds. Funds can invest in a wide variety of portfolio securities, including equities, fixed-income, government securities and derivatives and can have a wide variety of strategies, including index-tracking products, smart beta products, and products that are actively managed. Funds may focus on a particular industry, geographic area or market capitalisation. Registered investment companies are typically organised in Massachusetts, Delaware or Maryland. Open-end funds are continuously offered with daily liquidity, while closed-end funds are underwritten and offer liquidity in the secondary market at market prices which are often at a discount to net asset value. The funds are registered under the Investment Company Act and shares are registered under the Securities Act.

1.2 Raising Capital from Investors

PE

Private equity funds formed in the US are generally used for raising capital both from US and international investors. Some international investors, as well as some US tax-exempt investors, may prefer to invest in feeder or parallel vehicles organised outside the US, such as in the Cayman Islands.

HF

The US is primarily used to raise capital from US taxable investors. US tax exempt and non-US investors are generally solicited for funds domiciled outside the US even for US based managers; provided that some US tax-exempt organisations, such as state pensions, may still invest through US entities.

RIC

Generally, registered investment companies are only available to US persons.

1.3 Common Process for Setting Up Investment Funds

PE, HF

In order to establish a fund, it will be formed (generally in Delaware) with a certificate of limited partnership or certificate of formation. Then, the operative and offering documents will be drafted (private placement memorandum, subscription documents, limited partnership agreement or limited liability company agreement, as applicable) prior to the fund commencing operations.

RIC

Registered investment companies are typically sponsored by an investment adviser, who then manages the fund's investments pursuant to an advisory agreement. Other service providers provide transfer agency, administration, accounting, custodial and distribution services pursuant to applicable agreements. After launch, funds are overseen by an independent board of directors.

1.4 Regulation of Fund Structures

PE, HF

Managers can be located anywhere, although it is not uncommon that managers are based in the US. Jurisdictional requirements depend on the manager's jurisdiction and place of business, except that managers need to consider registration or exemptions under the US Investment Advisers Act of 1940, as amended, and the Commodity Exchange Act.

RIC

Registered investment companies are typically managed by a US adviser, although this is not required. The adviser must be registered under the Advisers Act. Advisers will sometimes hire foreign sub-advisers to manage a portion of the assets pursuant to a sub-advisory agreement between the adviser and the sub-adviser, with the sub-adviser's fee paid by the adviser out of its advisory fee.

1.5 Limited Liability

PE, HF

Investors benefit from limited liability as limited partners (limited partnership) or members (limited liability company). Delaware has a robust policy of safeguarding the liability of limited partners and members. Legal opinions may be given in this respect; they are often requested for private equity funds, but are not typically given for hedge funds.

RIC

There is no practical liability for shareholders in the funds, therefore no legal opinions are typically required.

1.6 Common Tax Regimes

PE, HF

The most common US tax regimes for investment funds are the regimes applicable to:

- US corporations, which are generally subject to federal income tax at corporate income tax rates;
- non-US corporations, the taxation of which is depends on the nature of the income earned by the corporation;
- partnerships, which are fiscally transparent for income tax purposes; and
- certain types of wholly owned entities that are disregarded as entities separate from their owners for income tax purposes.

Private Equity funds tend to be formed as partnerships; hedge funds may be any of the above entities. The particular US tax regimes chosen for investment fund entities will depend on the nature of the income earned by the fund and the tax profile of the fund's investors. These considerations are discussed in more detail below.

RIC
Registered investment companies that satisfy certain requirements relating to the diversification of their assets and sources of income can elect to have pass-through taxation, so the fund itself does not pay taxes, but passes through its gains and income to the shareholders in the fund.

1.7 Investment Sponsors
Given the plethora of investors, including governmental entities, corporate pension plans, insurance companies, university endowments, family offices and high net worth individuals, to name a few of the categories, the US is a very popular jurisdiction for any fund seeking capital.

1.8 Disclosure Requirements
PE, HF
While there is no legal requirement to provide a PPM, many PE funds sponsors often provide one as both a form of marketing and disclosure. It is similarly customary for hedge fund managers to provide a PPM. The PPM usually describes the investment strategy of the sponsor and provides legal disclosures regarding the securities offering. To the extent a PPM is prepared and provided, it cannot possess any misleading or false information, nor can it omit any information material to the offering.

RIC
The offering documents are the prospectus and statement of additional information, which are part of the registration statement that is filed with the SEC and is publicly available. A summary prospectus can satisfy the delivery requirements, although the statutory prospectus must be available on the fund's website. A statutory prospectus will be sent to the shareholder at his or her request.

1.9 Legal Forms
PE
Private equity funds are usually formed as limited partnerships. A limited partnership has both a general partner and limited partners. The general partner participates in management and shares the profits and losses of the fund. The general partner is also liable for all debts and obligations of the partnership. Limited partners, however, generally do not participate in management, and are only liable to the extent of their investment in the partnership.

HF
Hedge funds are primarily formed as limited partnerships with the manager, or a special-purpose vehicle controlled by the manager, acting as the general partner of the limited partnership. Alternatively, hedge funds may be formed as limited liability companies, with the manager acting as the manager.

RIC
Registered investment companies must be organised in a US state. Typical legal forms for funds are Delaware statutory trusts, Massachusetts business trusts, Maryland corporations and, to a limited extent, Delaware limited liability corporations. The first mutual funds were organised as Massachusetts business trusts, so historically that form was the most popular. Statutory changes to Maryland and Delaware law in the 1980's made these jurisdictions more attractive, and now Delaware statutory trusts are the most popular due to a comprehensive regime specific to statutory trusts and a history of corporate experience in the courts.

1.10 Regulatory Status
PE, HF
Private equity funds and hedge funds generally operate under exemptions to the Investment Company Act, the Securities Exchange Act of 1934, as amended, and the Securities Act of 1933, as amended. Exemptions typically are organised around private offerings and investor sophistication thresholds. These funds are not generally subject to regular public disclosure requirements. The investment adviser to these funds is often registered with the US Securities and Exchange Commission if it has in excess of USD150 million in assets under management.

RIC
As noted above, registered investment companies must have their offering documents approved by the SEC and are subject to ongoing regulation by the SEC.

1.11 Legal, Regulatory or Tax Legislative Changes
PE, HF
The legal and regulatory environment in the US is relatively stable currently.

Recent tax reform in the US has resulted in numerous changes that are relevant to the investment fund industry, including changes to income tax rates and the taxation of carried interest, as well as the implementation of limitations on the deductibility of investment management fees, state and local taxes and business interest. Since the tax reform legislation was adopted, the US Treasury Department has issued, and is expected to continue issuing, regulations and other guidance implementing and interpreting various aspects of the tax reform law, including those provisions of the tax reform legislation most relevant to funds and their investors.

RIC
New rules will put into place a formal structure for registered investment companies on liquidity risk management, certain restrictions on illiquid investments, and disclosure requirements. A new rule will allow e-delivery of periodic shareholder reports, if certain conditions are met. A new rule has been proposed that will allow the launch of ETFs without obtaining an exemptive order, among other changes, including disclosure requirements.

2. Fund Investment

2.1 Types of Investors

PE
Investors in private equity funds are typically large institutional investors, including pension plans, university endowments, insurance companies and funds-of-funds. Over the past few years there has been an increase in the number of high net worth individuals and family offices investing in private equity funds.

HF
Investors in the US tend to be taxable high net worth individuals, institutional investors, and family offices.

RIC
Registered investment companies are generally available to any investor, including those without financial sophistication or a high net worth. More than half of US households have assets in registered investment companies, including through their tax-advantaged retirement accounts.

2.2 Legal, Regulatory and Investment Structures

PE, HF
Investors prefer to enter US-based limited partnerships or limited liability companies, operating under exemptions to the US federal regulatory laws.

RIC
Investors tend to be agnostic in legal structure.

2.3 Legal, Regulatory or Tax Themes/Issues

PE
A common theme among private equity funds in the US is the limited liability investors enjoy by investing into limited partnerships or limited liability companies. Tax issues are noted below.

HF
Investments in US-domiciled funds are usually suitable only for US taxable investors or for certain US state pensions. Common tax issues for investors in the US are discussed in more detail below.

2.4 Restrictions on Investors

PE, HF
Investors must qualify under minimum suitability thresholds as accredited investors and often as qualified purchasers. If performance fees/allocations are charged and investors are not required to be qualified purchasers, investors would be required to be qualified clients. If futures contracts (including non-securities based swaps are traded), consideration should also be given to the qualified eligible person status under the CFTC rules. Additionally investors will be subject to US federal income tax.

RIC
Generally there are no restrictions on investing in particular mutual funds, although some funds and share classes are restricted by minimum investments or investor type.

2.5 Marketing Restrictions

PE, HF
Typically fund offerings rely on private offerings to secure exemptions. Therefore, marketing generally is on a focused basis, and general solicitation typically is avoided. Under the newer Rule 506(c) of the Securities Act of 1933, sponsors can advertise to anyone as long as they only accept accredited investors into the fund. Under Rule 506(c), the sponsor must take "reasonable steps" to ensure that all of its investors are accredited – it cannot simply rely on the investor's self-certification that it is an accredited investor.

RIC
Generally the Securities Act prohibits the offer of registered investment company shares, unless pursuant to a prospectus. However, there are exceptions to this. A fund can satisfy its prospectus delivery requirements by providing a summary prospectus. In addition, a fund complex may have generic advertising, which does not refer to a particular fund, among other restrictions and disclosure requirements. A fund may use advertisements/newsletters/supplemental sales literature in a variety of other manners, which have stringent requirements on disclosure. The Securities Act also contains general anti-fraud protections.

3. Regulatory Environment

3.1 Regulatory Regime

PE, HF
Investment managers, ie, a person who, for compensation, engages in the business of advising others as to the advisability of investing in, purchasing, or selling securities, with

assets under management of at least USD150 million, typically are regulated by the SEC under the Investment Advisers Act. Depending on the activities of the fund, these persons may also have to register as a Commodity Pool Operator or Commodity Trading Adviser under the CFTC. However, investment managers may qualify under certain CFTC exemptions causing them not to have to register as a CPO or CTA. Smaller advisers register under state law with state securities authorities. Investment advisers register with the SEC by filing a Form ADV and have certain annual requirements under the Advisers Act. Each registered adviser must file an annual updating amendment to its Form ADV which must be filed within 90 days of the adviser's fiscal year end.

RIC

The Securities and Exchange Commission is the main regulator for registered investment companies. The SEC reviews and comments on registration statements, proxy statements and other filings. New funds can typically launch two to three months after initial filings are completed, which would include discussions with the SEC on their review and resolution of any comments. Other important regulators include FINRA, state or "blue sky" authorities, the CFTC, and the IRS.

3.2 Territorial Reach of Regulators

PE, HF

The SEC takes an extraterritorial approach to regulation, as does the CFTC.

RIC

The SEC has authority over any registered investment companies that are registered in the US. Managers outside the US may provide services to US-registered funds, but managers are typically resident in the US.

3.3 Regulatory Approval

PE, HF

Marketing private equity and hedge funds in the US does not require regulatory approval.

RIC

FINRA does not directly regulate registered investment companies, but most sales literature related to registered investment companies is filed with and reviewed by FINRA, as most mutual funds are distributed by FINRA member firms.

3.4 Authorisation of Marketing Activities

PE, HF

The marketing activities of private equity and hedge funds in the US do not require authorisation from any government or regulatory body. It should be noted however, that if the sponsor is paying transaction-based compensation to its internal marketing personnel, consideration should be given to broker-dealer registration with the SEC.

RIC

FINRA requires notification but not pre-approval.

3.5 Investor-Protection Rules

PE, HF

Investors typically must be qualified purchasers, qualified clients, and/or accredited investors under US regulatory laws to qualify for exemptions. Additionally, if an adviser is using an exemption under the Commodity Exchange Act, investors must also meet the definition of a qualified eligible person.

3.6 Approach of the Regulator

PE, HF

Regulators tend to have routine contact with managers and periodically conduct compliance investigations and issue guidance on novel or contentious issues.

RIC

The SEC is generally co-operative to discuss regulatory issues and meet the fund's timelines. They regularly publish guidance on current issues in the marketplace, as well as FAQ's on recently-enacted rules. The SEC regularly conducts exams and certain exams lead to referrals to the Division of Enforcement.

4. Fund Finance

4.1 Access to Fund Finance

PE

Private equity funds in the US commonly utilise subscription lines of credit, which are typically revolving credit facilities. Fund level leverage is not standard for private equity funds.

HF

Funds are permitted and often do use leverage through prime brokers and other credit advisers. Funds of hedge funds may secure financing from banks or their affiliates, either through traditional credit facilities or through derivative instruments.

4.2 Borrowing Restrictions/Requirements

PE

While there are no legal or regulatory issues or restrictions governing a private equity fund's ability to incur leverage, there are often tax implications of doing so which may affect an investor's interest in a fund. Therefore, restrictions on a fund's ability to borrow is often negotiated in the operative documents.

HF

Regulation T, U and X under the Securities Exchange Act of 1934 may apply, thereby limiting the amount of margin that may be utilised to leverage a portfolio of securities, but this area of law is complex.

RIC
Generally, registered investment companies can borrow only from banks and only in an amount up to 33 1/3% of its assets. If a closed-end fund issues preferred stock, it can borrow in an amount up to 50% of its assets. Under certain circumstances, funds may also set up inter-fund lending facilities, whereby affiliated funds may borrow and lend to each other.

4.3 Securing Finance

PE
Subscription line credit facilities are typically secured through a revolving credit agreement that is negotiated with a bank. The General Partner usually pledges the right to call and receive the capital commitments of the investors. Typically, no actions are required by the investors themselves.

HF
Finance is generally secured by pledges of underlying assets and/or of accounts holding these assets.

RIC
Finance is typically secured through a credit agreement with banks or an inter-fund lending agreement.

4.4 Common Issues in Relation to Fund Finance

PE
Issues tend to be specific to the sponsor and the lender. There are no common issues that arise.

HF
Issues tend to be idiosyncratic, but tend to focus on the types of collateral that may be pledged and the types of events of default or termination.

RIC
The most important concern is maintaining the required asset coverage ratio.

5. Tax Environment

5.1 Tax Framework

PE
Limited partnerships (and limited liability companies that elect to be taxed as partnerships) are flow-through entities for tax purposes, meaning that profits and losses flow directly to the partners.

HF
Fund structures may involve a mix of corporate and fiscally transparent entities for US tax purposes in order to accommodate the US tax preferences of the fund's investors. Corporations are potentially subject to US federal income and withholding taxes, depending on the jurisdiction in which they are formed and the nature of their income. Distributions from corporations may also be subject to US withholding tax under certain circumstances. Partnerships generally are not subject to an entity-level federal income tax, but may be subject to withholding taxes and may also be required to withhold on income allocated or distributions made to non-US partners. Disregarded entities are not subject to income tax. Certain entities may be eligible to elect their US tax classification, subject to various restrictions.

5.2 Tax Treaty Network

The US is a party to numerous income tax treaties with other countries. Under these treaties, residents of non-US countries may be subject to tax at a reduced rate, or may be exempt from US taxes on certain items of income (eg, dividends) they receive from sources within the US. If investors are residents in countries that are parties to income tax treaties with the US, it may be desirable to structure the investment entities in which those investors hold direct or indirect interests as "reverse hybrid" entities (ie, entities that elect to be treated as corporations for US tax purposes but are treated as fiscally transparent outside the US). Using reverse hybrid entities may allow non-US investors to obtain the benefits of relevant treaty provisions that would not be available if the entity was opaque for non-US tax purposes.

5.3 FATCA and CRS Regimes

FATCA generally requires that non-US financial institutions and certain other non-financial entities report on the non-US assets held by their US account-holders. Failure to comply with FATCA may subject these entities to the US withholding on certain withholdable payments.

5.4 Tax Structuring Preferences of Investors

US taxable investors generally are subject to US federal income tax on their worldwide income. If a US taxable investor invests in a fund through a fiscally transparent entity, the income generated by that investment will be subject to a single layer of tax at the investor level. On the other hand, if the investor invests in a US entity taxed as a corporation, the corporation will pay tax at regular corporate rates on its income and distributions of the after-tax income will be subject to tax when received by the US taxable investor. In addition, anti-deferral rules applicable to investments by US taxable investors in non-US corporations generally will make investments through those entities inefficient from a tax perspective. As a result, most US taxable investors prefer to invest in funds through fiscally transparent entities.

Many US tax-exempt investors are only subject to tax in the US on so-called "unrelated business taxable income" or "UBTI". In general, UBTI is income attributable to a trade or business of the investor that is unrelated to the purpose providing the basis for its tax-exempt status. Most passive investment income (eg, dividends, interest, capital gains) is not treated as UBTI unless the investment in the assets generating the income is debt-financed. For the purpose of these rules, the activities of a fiscally transparent entity will be imputed to the US tax exempt investor. As a result, US tax-exempt investors (other than certain state/local exempt organisations that qualify for an exclusion from tax on their UBTI) generally prefer to invest in entities that are treated as corporations for US tax purposes. This protects the investors from recognising UBTI that might result if the fund uses leverage as part of its trading strategy or is determined to be engaged in an unrelated trade or business. As between domestic and non-US corporations, in cases where the fund's investment activity is not expected to generate income effectively connected with a trade or business in the US (ECI), most US tax-exempt investors prefer to invest through non-US corporations in jurisdictions without a corporate income tax (eg, the Cayman Islands). While the non-US corporation will be subject to withholding taxes on certain types of US-source investment income (eg, dividends), it generally will not be subject to the corporate-level income tax that would apply to all of a domestic corporation's income.

Like US tax-exempt investors, non-US investors will typically seek to invest in funds through non-US corporations in jurisdictions without a corporate income tax. While the non-US corporation may be subject to withholding taxes on certain types of US-source income generated by the fund, unless the fund's trading activities generate ECI, neither the corporation nor the non-US investor will be subject to income tax in the US. In addition, an investment in a non-US corporation generally, will not, by itself, require a non-US investor to file tax returns in the US that it might be required to file if it invested through a fiscally transparent entity.

In cases where a fund's investment activity is expected to generate ECI or regular (as opposed to debt-financed) UBTI, US tax-exempt or non-US investors will typically seek to hold their interests in those investments through US entities taxed as corporations. Investing through a fiscally transparent entity would require the investor to file tax returns and pay tax in the US on the income attributable to those investments.

To accommodate these varying preferences, hedge funds are typically arranged using "onshore" and "offshore" investment vehicles, which often feed into a single "master fund." The onshore fund is generally offered to US taxable investors and is typically formed as a US fiscally transparent entity (eg, a Delaware limited liability company or limited partnership). The offshore fund and master fund are typically formed in a non-US jurisdiction that does not impose a net income tax (eg, the Cayman islands). The offshore fund typically elects to be treated as a corporation for US federal income tax purposes. The master fund typically elects to be treated as fiscally transparent for US federal income tax purposes. In cases where some or all of a fund's investments are expected to generate ECI/UBTI, alternative structures are often established for the benefit of non-US and US tax-exempt investors that allow those investors to hold their interests in those investments indirectly through US corporations.

Private equity and other investment fund structures can vary significantly depending on the nature of the fund's investments, but the investment vehicles in those structures are often formed as one or more fiscally transparent entities. Depending on the nature of the fund's investments, non-US and US tax-exempt investors may be offered parallel or alternative investment fund options that are or invest through corporations for US federal income tax purposes.

6. Miscellaneous

6.1 Asset Management Industry Bodies

PE: The American Investment Council, formerly the Private Equity Growth Capital Council, was launched in 2007 by a consortium of private equity firms to conduct lobbying, advocacy, and research. Its primary goal is to promote the private equity industry to lawmakers and the general public.

HF: Managed Funds Association, National Futures Association.

RIC: The most prominent industry association is the Investment Company Institute, which represents regulated funds globally, including mutual funds, ETF's and closed-end funds. The ICI seeks to advance the interests of funds, their shareholders, directors, and advisers.

6.2 Preference for Courts or Arbitration

This will depend on the preferences of the fund manager. Some believe that arbitration can be quicker and less expensive than litigation in court, although that has not always been borne out in reality. Arbitration matters are also generally more confidential than court records.

6.3 Level of Litigation/Arbitration

The US is a litigious setting. However, the funds area is not one in which there is particularly more litigation than in other areas.

6.4 Periodic Reporting Requirements

PE, HF: Funds typically provide tax reporting and audited financial statements to investors annually; some funds may also provide information about their investments to investors on a quarterly basis. These are not publicly available. A registered investment adviser will complete forms related to their investments that are filed with the regulator. These are not publicly available. A registered investment adviser will also complete forms related to their business structure filed with the regulator that are publicly available. Funds will file forms with the SEC about the fund and basic business information. These are publicly available.

RIC: There are a variety of periodic reporting requirements, including annual and semi-annual reports, reports of portfolio holdings, and census-type information. This information is generally publicly available, although due to recent changes in reporting requirements, reports of portfolio holdings will be delayed or confidential.

6.5 Powers of Attorney

PE, HF: Investors normally give a power of attorney to fund managers so that the managers can take certain actions. Typically, this power of attorney is limited to authorising the general partner to act on the limited partner's behalf in order to vote on the fund's securities, buy and sell securities, admit new limited partners, and make investor-favourable amendments to the governing documents.

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