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Investment Funds

USA

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Law and Practice

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1. Market Overview

1.1 State of the Market

The responses to the sections on private equity funds (PEs) and hedge funds (HFs) have been responded to with respect to alternative investment funds. Sections on registered investment companies (RICs) with respect to retail funds. Hedge funds, private equity funds and RICs are the three main types of funds in the USA.

Sponsors and managers commonly use the USA as the jurisdiction for the formation of alternative investment funds such as private equity and hedge funds, as well as retail funds or registered investment companies. This is particularly true for funds that are intended to attract investments from US investors and make investments in US targets. Delaware is the preferred jurisdiction for most US private equity funds and hedge funds because the two laws that typically control fund entities, the Delaware Revised Uniform Limited Partnership Act and the Delaware Limited Liability Company Act, 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.

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 USA is a very popular jurisdiction for any fund seeking capital.

2. Alternative Investment Funds

2.1 Fund Formation

2.1.1 Fund Structures

Common structures of hedge and private equity funds are limited partnerships or limited liability companies operating under exemptions to the US federal regulatory laws.

2.1.2 Common Process for Setting up Investment Funds

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, and investment management agreement) prior to the fund commencing operations. Hedge funds also typically enter into administration agreements with third-party administrators and various trading agreements with prime brokers.

2.1.3 Limited Liability

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.

2.1.4 Disclosure Requirements

Private equity funds and hedge funds generally operate under exemptions to the Investment Company Act, the Securities Exchange Act of 1934 and the Securities Act of 1933. Exemptions typically are organised around private offerings and investor sophistication thresholds. Such funds are not generally subject to regular public disclosure requirements. However, while there is no legal requirement to provide a private placement memorandum (PPM), many PE and hedge fund sponsors often provide one as both a form of marketing and disclosure. 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.

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.

2.2 Fund Investment

2.2.1 Types of Investors in Alternative Funds

Investors in the United States tend to be taxable high net worth individuals, institutional investors and family offices. Institutional investors – particularly pension funds, university endowments, and charitable foundations – have been more actively investing in alternative investment funds such as private equity funds and hedge funds due to the diversification benefits these products may offer.

2.2.2 Legal Structures Used by Fund Managers

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.

Private equity funds are primarily formed as limited partnerships, with a special purpose vehicle controlled by the sponsor of the fund acting as the general partner.

2.2.3 Restrictions on Investors

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

2.3 Regulatory Regime

2.3.1 Regulatory Regime

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 US Investment Advisers Act of 1940. Depending on the activities of the fund, such persons may also have to register as a Commodity Pool Operator (CPO) or Commodity Trading Advisor (CTA) 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.

2.3.2 Requirements for Non-local Service Providers

The SEC takes an extraterritorial approach to regulation, as does the CFTC. Therefore, non-local service providers are subject to substantially similar regulatory requirements with which local service providers are required to comply.

2.3.3 Local Regulatory Requirements for Non-local Managers

Local regulatory 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 and the Commodity Exchange Act.

2.3.4 Regulatory Approval Process

Private equity funds and hedge funds generally do not require regulatory pre-approvals. Regulatory approval for sponsors of hedge funds and private equity funds may be required under the US Investment Advisers Act of 1940 and the Commodity Exchange Act, and may take between one and several months to become registered.

2.3.5 Rules Concerning Marketing of Alternative Funds

Marketing private equity and hedge funds in the USA does not require regulatory approval. Typically, fund offerings rely on private offerings to secure exemptions. Therefore, marketing generally is on a focused basis, and general solicitation is typically avoided. 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. The SEC has also recently proposed an amendment to its "cash solicitation" rules that could require increased disclosure of compensation paid to solicitors of hedge funds and private equity funds.

2.3.6 Marketing of Alternative Funds

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. More typically, hedge funds and private equity funds are offered under 506(b) of the Securities Exchange Act of 1933, which requires a substantive pre-existing relationship with the prospective offeree and the offering not to be made pursuant to general solicitation.

2.3.7 Investor Protection Rules

Investors in hedge funds typically must be qualified purchasers, qualified clients and/or accredited investors under US securities 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.

Investors in private equity funds typically must be accredited investors under US securities laws. Depending on the exemption from the Investment Company Act that the sponsor is relying on, investors may also need to be qualified purchasers. Lastly, in order for the general partner to take incentive or performance fees, the investors also need to be qualified clients.

2.3.8 Approach of the Regulator

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

2.4 Operational Requirements

Investment advisers to private equity and hedge funds are often registered with the SEC if they have in excess of USD150 million in assets under management. If the investment adviser trades commodity interests, it will also have to be registered with the CFTC or have a valid exemption from registration.

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

Investment advisers are required to comply with the US Investment Advisers Act of 1940, which includes rules regulating custody of client assets. Funds are subject to general securities lawyers prohibiting insider trading and advisers are generally required to disclose all material conflicts of interest.

2.5 Fund Finance

Hedge funds are permitted and often 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. Financing is generally secured by pledges of underlying assets and/or of accounts holding such assets.

In relation to borrowing, 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.

Issues related to fund finance 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.

Private equity funds often enter into subscription facilities, pursuant to which they can borrow money to fund investments pending receipt of capital calls from investors. These facilities are intended to ease the administrative burden on investors from having to make too many capital calls in any given month or quarter. Typically, these are the only types of credit facilities that private equity funds use, as there is generally a bias against permitting private equity funds to borrow, as doing so can have adverse tax consequences to tax-exempt or non-US investors. These subscription facilities are usually prepared so that the general partner pledges its right to call capital from the investors, so that the investors are generally not involved in the facility.

2.6 Tax Regime

The most common US tax regimes for alternative funds are the regimes applicable to (i) US corporations, which are generally subject to federal income tax at corporate income tax rates; (ii) non-US corporations, the taxation of which depends on the nature of the income earned by the corporation; (iii) partnerships, which are fiscally transparent for income tax purposes;

and (iv) certain types of wholly owned entities that are disregarded as entities separate from their owners for income tax purposes.

Alternative fund structures may involve a mix of the foregoing entities 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.

US taxable investors generally are subject to US federal income tax on their worldwide income. In the case of US taxable investors that are treated as corporations under US tax law, all of their income, regardless of its character, will be subject to tax at the corporate tax rate (currently 21%). In the case of individuals, ordinary income and short-term capital gains are subject to tax at graduated rates, with the highest marginal rate currently set at 37%, while long-term capital gains and qualified dividend income generally are subject to tax at a lower rate (currently 20%). In addition, regardless of the character of income, a 3.8% tax is imposed on an individual's net investment income.

If a US taxable investor invests in an alternative 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 USA on so-called unrelated business taxable income (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 purposes 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 (i) uses leverage as part of its trading strategy or (ii) 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 USA (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 will generally 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 USA. 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 USA 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 USA 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.

3. Retail Funds

3.1 Fund Formation

3.1.1 Fund Structures

The USA 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. Open-end funds are continuously offered with daily liquidity, while traditional 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. Closed-end funds known as interval or tender offer funds are continuously offered with a variety of periodic repurchase features. The funds are registered under the Investment Company Act and shares are registered under the Securities Act.

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 most popular. Statutory changes to Maryland and Delaware law in the 1980s 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. Investors tend to be agnostic in legal structure.

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.

3.1.2 Common Process for Setting up Investment Funds

Registered investment companies are typically sponsored by an investment adviser, which then manages the fund's investments pursuant to an advisory agreement. After launch, funds are overseen by an independent board of directors.

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 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.

The SEC reviews and comments on registration statements. New funds can typically launch two to three months after initial filings are completed, which would include discussions with the SEC on its review and resolution of any comments. The cost is highly variable, depending on the sponsor and the product.

3.1.3 Limited Liability

There is no practical liability for shareholders in the funds.

3.1.4 Disclosure Requirements

There are significant and complicated disclosure and reporting requirements, which include the filing of financial reports, offering documents and reports of portfolio holdings.

3.2 Fund Investment

3.2.1 Types of Investors in Retail Funds

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.

3.2.2 Legal Structures Used by Fund Managers

As discussed above, typical legal forms for funds are Delaware statutory trusts, Massachusetts business trusts, Maryland corporations and, to a limited extent, Delaware limited liability corporations.

3.2.3 Restrictions on Investors

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.

3.3 Regulatory Environment

3.3.1 Regulatory Regime

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 its review and resolution of any comments. Other important regulators include the Financial Industry Regulatory Authority (FINRA), state or "blue sky" authorities, the CFTC and the Internal Revenue Service (IRS).

There are restrictions on investments, including certain restrictions on the use of derivatives, investment in other funds and transacting with affiliates.

3.3.2 Requirements for Non-local Service Providers

There are significant regulatory restrictions and requirements for any service providers to funds.

3.3.3 Local Regulatory Requirements for Non-local Managers

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

3.3.4 Regulatory Approval Process

As discussed above, regulatory approval typically takes approximately two to three months.

3.3.5 Rules Concerning Marketing of Retail Funds

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.

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.

3.3.6 Marketing of Retail Funds

As discussed above, registered investment companies are generally available to any investor, including those without financial sophistication or a high net worth.

3.3.7 Investor Protection Rules

As discussed above, registered investment companies are generally available to any investor, including those without financial sophistication or a high net worth.

As discussed above, there are significant and complicated disclosure and reporting requirements, which include the filing of financial reports, offering documents and reports of portfolio holdings.

3.3.8 Approach of the Regulator

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

3.4 Operational Requirements

These funds are highly regulated, so there are restrictions on the types of activities and investments as discussed above, as well as stringent regulatory safeguards on the fund's assets and the fund's custodian.

3.5 Fund Finance

Generally, registered investment companies can borrow only from banks and only in an amount up to 33⅓% 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 interfund lending facilities, whereby affiliated funds may borrow and lend to each other. The most important concern is maintaining the required asset coverage ratio.

3.6 Tax Regime

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.

4. Legal, Regulatory or Tax Changes

4.1 Recent Developments and Proposals for Reform

New rules have been adopted that (i) require a formal structure for registered investment companies on liquidity risk management, certain restrictions on illiquid investments, and disclosure requirements; (ii) allow e-delivery of periodic shareholder reports if certain conditions are met; and (iii) allow the launch of ETFs without obtaining an exemptive order, among other changes, including to disclosure requirements. New rules have been proposed that will (i) formalise the permissible use of derivatives by the funds and (ii) modernise the rules for advertising by investment advisers.

USA LAW AND PRACTICE

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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 sub-

stantial 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.

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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

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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,

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