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The International Comparative Legal Guide to:

Alternative Investment Funds 2015

3rd Edition

A practical cross-border insight into Alternative Investment Funds work

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1 Regulatory Framework

1.1 What legislation governs the establishment and operation of Alternative Investment Funds?

In the United States, Alternative Investment Funds and their advisers are subject to the laws of the federal government and of the individual state or jurisdiction in which the entities are incorporated, doing business and/or selling securities.

At the federal level, investment companies organised in and/or operating in the United States, including Alternative Investment Funds, are generally subject to the jurisdiction of the Securities and Exchange Commission ("SEC"). The SEC's jurisdiction comes by way of the Investment Company Act of 1940, as amended ("Investment Company Act"), which governs the activities of investment companies, and the Investment Advisers Act of 1940, as amended ("Advisers Act"), which governs the operations and activities of investment advisers. In addition, the offering and sale of interests in Alternative Investment Funds is regulated by the SEC under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"), and are also regulated by the Financial Industry Regulatory Authority ("FINRA"), a self-regulatory agency.

In addition, depending on the activities of the fund, other federal regulators may have jurisdiction over the fund or its adviser. Alternative Investment Funds that invest in futures, options on futures, or swaps (other than certain security-based swaps) are subject to the jurisdiction of the Commodity Futures Trading Commission ("CFTC"). Further, Alternative Investment Funds sponsored by banks or bank holding companies may also be subject to certain requirements under the federal banking laws and may be subject to the jurisdiction of the Board of Governors of the Federal Reserve System ("Federal Reserve"). Alternative Investment Funds that trade or invest in electricity are subject to regulation by the Federal Energy Regulatory Commission ("FERC").

Most Alternative Investment Funds operating in the United States are formed as limited partnerships or limited liability companies, and are therefore subject to the laws of their state or jurisdiction of incorporation. Alternative Investment Funds offered in the United States may be formed either under the laws of a U.S. state or in a non-U.S. jurisdiction. Alternative Investment Funds that are domiciled in the United States are typically formed in the state of Delaware, which offers well-established statutes governing the formation and operation of alternative entities, including the limited liability protections applicable to investors in such entities. Delaware also has sophisticated court systems that are experienced in matters involving alternative entities, and the governing statutes generally support the principles of freedom of contract among sponsors, managers and investors to order their affairs as they wish. All of these factors make Delaware the most common choice for U.S.-domiciled Alternative Investment Funds.

1.2 Are managers or advisers to Alternative Investment Funds required to be licensed, authorised or regulated by a regulatory body?

Investment advisers to Alternative Investment Funds are subject to regulation by the SEC under the Advisers Act and by the state securities regulators in the states in which the adviser conducts business.

In general, an adviser is required to register with the SEC if it has at least $100 million in assets under management ("AUM"), subject to certain exemptions. Advisers with less than $100 million in AUM are generally prohibited from registration with the SEC and instead must comply with the registration requirements of the states in which the adviser conducts business. The state-level registration requirements and exemptions vary on a state-by-state basis.

Registering as an investment adviser with the SEC provides for pre-emption from the various state registration requirements. However, investment advisers that are exempt from registration with the SEC, or ineligible to register with the SEC based on their AUM, may be required to comply with multiple states' investment adviser regimes. Further, under the SEC's "territorial" approach to Advisers Act jurisdiction, a non-U.S. adviser that is registered with the SEC is generally subject to the substantive requirements of the Advisers Act only with respect to its U.S. clients.

In 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") revised the exemptions applicable to investment advisers in the United States. Prior to the Dodd-Frank Act, many investment advisers were exempt from both SEC and state registration by virtue of the "private adviser exemption", which exempted any adviser that (i) had fewer than 15 clients during the course of the preceding 12 months, and (ii) neither held itself out generally to the public as an investment adviser nor acted as an investment adviser to any registered investment company or business development company. The Dodd-Frank Act eliminated the private adviser exemption and in its place introduced certain narrower exemptions, which are summarised below:

1.2.1 Foreign Private Adviser Exemption

To be eligible for the Foreign Private Adviser Exemption, an adviser must: (i) have no place of business in the United States; (ii) have, in total, fewer than 15 clients (e.g., managed accounts or pooled investment vehicles) and investors in the United States in private funds advised by the investment adviser; (iii) have less than $25 million in aggregate assets under management that are attributable to clients in the United States and investors in the United States in private funds advised by the investment adviser; and (iv) neither hold itself out generally to the public in the United States as an investment adviser nor act as an investment adviser to any registered investment company or business development company.

Advisers relying on the Foreign Private Adviser Exemption are not subject to reporting or recordkeeping provisions under the Advisers Act and are not subject to examination by the SEC. While this exemption is narrow in scope, the full exemption it provides from the Advisers Act is desirable for many non-U.S. investment advisers.

1.2.2 Private Fund Adviser Exemption

The Private Fund Adviser Exemption provides an exemption for investment advisers to private funds only with less than $150 million in assets under management in the United States. For investment advisers with their principal office and place of business outside the United States, the exemption applies if (x) the investment adviser has no client that is a U.S. person except for one or more private funds,[1] and (y) all assets managed by the investment adviser at a place of business in the U.S. are solely attributable to private fund assets, with a total value of less than $150 million.

Advisers exempt under the Private Fund Adviser exemption are subject to certain SEC reporting and recordkeeping requirements with respect to their private funds. The "place of business" requirement allows a non-U.S. adviser to manage an unlimited amount of private fund assets from outside the United States, which allows many non-U.S. advisers to make use of the Private Fund Adviser Exemption.

1.2.3 Venture Capital Fund Adviser Exemption

The Venture Capital Fund Adviser Exemption exempts from registration investment advisers that solely advise venture capital funds. The definition of "venture capital fund" is relatively narrow, and encompasses any private fund that: (i) holds no more than 20 per cent of the fund's capital commitments in non-qualifying investments as defined by the SEC (other than short-term holdings); (ii) does not borrow or otherwise incur leverage, other than limited short-term borrowing (excluding certain guarantees); (iii) does not offer its investors redemption or other similar liquidity rights except in extraordinary circumstances; (iv) represents itself as pursuing a venture capital strategy to its investors and prospective investors; and (v) is not registered under the Investment Company Act and has not elected to be treated as a business development company.

Like the Private Fund Adviser Exemption, advisers exempt under the Venture Capital Fund Adviser Exemption are subject to certain SEC reporting and recordkeeping requirements with respect to their private funds.

Advisers relying on the Private Fund Adviser Exemption or the Venture Capital Fund Adviser Exemption are referred to as "exempt reporting advisers" by the SEC, reflecting the fact that these advisers are not registered but are subject to SEC reporting and recordkeeping requirements.

1.3 Are Alternative Investment Funds themselves required to be licensed, authorised or regulated by a regulatory body?

In the United States, Alternative Investment Funds are regulated pursuant to the Investment Company Act. However, most Alternative Investment Funds qualify for an exemption or exclusion from registration under the Investment Company Act and therefore from most of its substantive requirements. Most Alternative Investment Funds are designed to qualify for the exclusions provided by Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. Section 3(c)(1) provides an exclusion for any fund whose securities are beneficially owned by not more than 100 persons and which does not publicly offer its securities. Section 3(c)(7) provides an exclusion for any fund whose securities are owned exclusively by "qualified purchasers"; i.e., purchasers who meet certain net worth/investor sophistication tests and which do not publicly offer their securities. Alternative Investment Funds that are exempt from registration are still subject to certain requirements under the Investment Company Act, such as anti-pyramiding requirements that limit investments in U.S.-registered investment companies.

Further, investment advisers to Alternative Investment Funds are regulated pursuant to the Advisers Act as described above. When an adviser registers under the Advisers Act, the adviser is required to report certain information about the adviser's Alternative Investment Funds to the SEC on both Form ADV (the SEC's annual reporting form, which is publicly available) and Form PF (a private fund reporting form which is kept confidential by the SEC). The SEC conducts periodic examinations of registered investment advisers, and at such examinations the SEC may inspect records relating to any Alternative Investment Funds advised by the investment adviser.

1.4 Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds) and if so how?

In general, the U.S. regulations do not distinguish between open-ended and closed-ended Alternative Investment Funds. The new private fund reporting regime on Form PF seeks different information for hedge funds (which generally allow redemption rights) and private equity funds (which generally do not allow redemption rights in the ordinary course); however this distinction does not impact the operations of the funds.

1.5 What does the authorisation process involve?

Unlike many other countries, the U.S. federal securities laws do not provide for any suitability requirements, capital requirements, or qualification requirements for owners and key personnel of investment advisers. Rather than providing a comprehensive regulatory regime, the Advisers Act provides for disclosure requirements and imposes on advisers a broad fiduciary duty to act in the best interests of their clients. As a result, investors have the responsibility to negotiate their own arrangements with investment advisers based on the disclosure they receive.

Investment advisers register with the SEC and with state securities regulators by filing Form ADV. Within 45 days of filing Form ADV, the SEC must either grant registration or institute an administrative proceeding to determine if registration should be denied.

Form ADV is publicly available and consists of the following parts:

1.5.1 Part 1A: this part requires information about the adviser's business practices, ownership and employees in a "check-the-box" or "fill-in-the-blank" format, although certain sections and schedules require brief, narrative disclosure about various matters, including disciplinary events. It is filed electronically with the SEC.

1.5.2 Part 1B: this part requires additional information about certain Part 1A responses, as well as narrative disclosure with respect to disciplinary events. It is only completed by advisers registered with one or more states and is filed electronically with the states.

1.5.3 Part 2A: this part is known as the "brochure". It requires a narrative, plain English response to a number of specific items, including a description of the business, fees and compensation, disciplinary information, and key risk factors. It is filed electronically with the SEC and delivered to clients.

1.5.4 Part 2B: this part is known as the "brochure supplement". It requires resumé-like information about certain personnel of the adviser who provide advisory services to the particular client. The brochure supplement does not have to be filed with the SEC for federally-registered advisers but must be delivered to relevant clients of the adviser.

The SEC uses the information provided in Part 1 of Form ADV for regulatory purposes, including determining whether to approve the registration of a new adviser. Part 2 of Form ADV includes information that must be provided to clients. Advisers must keep their Form ADV current by filing periodic amendments as long as they are registered. Amendments are required promptly in accordance with Form ADV instructions in the event that certain types of information become inaccurate (such as identifying information, custody information and disciplinary information), or certain other types of information become materially inaccurate (such as information about successions, client transactions and control persons). Amendments are otherwise required at least annually within 90 days of the adviser's fiscal year end.

1.6 Are there local residence or other local qualification requirements?

The SEC does not impose any local residence requirements for a registered adviser. However, as part of the registration process, a non-U.S. adviser registering with the SEC or with a state must consent to appointing the Secretary of the SEC and/or the applicable secretary of state as the adviser's agent to receive service of process in the United States. Additionally, if an Alternative Investment Fund or its investment adviser is domiciled in a particular state, that state may have similar requirements regarding the appointment of an agent for service of process.

1.7 What service providers are required?

Alternative Investment Funds typically engage service providers including accountants, auditors, administrators and custodians. One or more prime brokers may be engaged as well, and the fund's manager will typically engage legal counsel with respect to the formation and offering of the Alternative Investment Fund.

Most of these engagements are customary rather than required, although in certain cases the applicable laws will indirectly require the use of certain service providers. For example, the Advisers Act requires that any registered adviser with custody of client funds or securities take certain steps to safeguard those assets. These steps include maintaining the client funds and securities with a "qualified custodian" (which includes banks, broker-dealers, and certain non-U.S. financial institutions that customarily hold such assets separate from their own). The qualified custodian may be the adviser or an affiliate thereof; although in such cases the adviser or affiliate is required to undergo an annual examination by an independent public accountant.

1.8 What co-operation or information sharing agreements have been entered into with other governments or regulators?

United States government authorities have entered into memoranda of understanding with numerous governments and regulators, including almost all EU countries in connection with the implementation of the AIFMD.

2 Fund Structures

2.1 What are the principal legal structures used for Alternative Investment Funds?

Private investment funds organised in the U.S. most commonly take the form of a limited partnership organised in Delaware. The Delaware limited partnership allows great flexibility in the terms governing the relationship between the sponsor, as general partner, and the investors, as limited partners. Delaware has a relatively well-developed body of law governing partnerships and experienced courts, and the resulting legal certainty together with the fact that practitioners in major legal centres in the U.S. are likely to be familiar with Delaware partnership law contribute to the general tendency to use Delaware partnerships. The limited partnership form's prevalence among private investment funds is attributable to the limited liability status it affords investors as limited partners, flow-through treatment for U.S. federal and state income tax purposes and the operational efficiencies of capital (as opposed to share) accounting. A Delaware limited liability company offers generally equivalent advantages, but it is currently less common as a vehicle for use with private investment funds. It has not overcome the tendency to stay with what is familiar. In addition, the limited liability company may attract franchise taxes in certain states of the United States and is not treated as transparent in certain non-U.S. jurisdictions for foreign tax and treaty purposes. Delaware statutory trusts offer advantages similar to those of a limited partnership but also are not commonly used for private investment funds.

Private investment funds are often structured as a complex of several pooled investment vehicles rather than one vehicle in order to accommodate the tax preferences of different types of investors (and occasionally regulatory requirements and investors' internal policies). A common approach is to establish "parallel" or "mirror" funds that invest in a side-by-side manner. This allows the form and jurisdiction of the organisation to be varied according to investor type, the most common variation being to house non-US investors within an entity located offshore in a tax-neutral jurisdiction such as the Cayman Islands. It also permits each parallel fund to structure its holding of particular portfolio investments or categories of investments in whatever manner is optimal for the investors in that parallel fund. For example, a parallel fund through which U.S. tax-exempt investors or foreign investors invest may hold certain investments through corporations, REITS or other vehicles that are non-transparent for tax in order to "block" income that might otherwise subject them directly to income tax or reporting requirements in the U.S. while choosing not to "block" for other investments.

The parallel fund structure is often used by private equity, real estate and other closed-ended funds likely to be holding investments large enough and for long enough to warrant structuring their holdings on a case-by-case basis. Hedge funds, on the other hand, often opt to forego this flexibility in favour of a "master-feeder" or "spoke-and-hub" structure. In this structure, investors subscribe for interests in "feeder funds" that in turn all invest in one "master" fund that holds all investments. Typically, U.S. taxable investors invest in an onshore feeder and foreign and U.S. tax-exempt investors invest through a "blocker" vehicle classified as a corporation for U.S. tax purposes and organised in a tax-neutral jurisdiction. By making all investments through a master fund, the "master-feeder" structure avoids the need to rebalance holdings among parallel funds as investors subscribe and redeem, and the loss of flexibility is a small price to pay given that the volume and velocity of hedge fund trading strategies tend to make it impractical to hold one investment or group of investments through multiple structures, and the nature of assets held tends to reduce the need to structure for tax. Another potential advantage of the "master-feeder" structure relates to "ERISA", the U.S. federal regime protecting U.S. private pension fund investors. Many private investment funds seek to avoid the application of ERISA by assuring that the portion of their equity held by private pension funds is not "significant" (generally assumed to mean 25 per cent or more of any class of equity). By assuring that all capital is invested through a master fund, the "master-feeder" structure opens up the possibility that, with certain additional precautions, this test can be performed by reference to U.S. private pension fund investors' indirect interest in the master fund as opposed to applying this test to each feeder fund vehicle in which these investors invest directly. This is helpful because U.S. private pension fund investment will tend to be concentrated in certain feeder fund vehicles, such as those established for U.S. tax-exempt investors.

2.2 Please describe the limited liability of investors.

The Delaware limited partnership statute provides that limited partners of Delaware limited partnerships are not liable for the obligations of the partnership unless they participate in the control of the business of the partnership. The statute does not define control for this purpose but it provides numerous safe harbours, including that no limited partner will be deemed to "participate in the control of the business" solely by virtue of exercising or possessing the rights granted to it under the partnership agreement. Accordingly, for example, voting as a limited partner or exercising control through a seat on a limited partnership advisory board provided for in the partnership agreement will fall within this safe harbour. Even if the limited partner's conduct falls outside of the statute's safe harbours, the limited partner will only be liable to persons transacting business with the limited partnership that reasonably believed, based upon the limited partner's conduct, that the limited partner is a general partner. The position under the limited liability company statute in Delaware is slightly better in that the statute contains no exception to limited liability status of its members based on participation in control or management, though this in most cases is not likely to be critical given the extensive protections described above for limited partners.

Note that the limited liability of limited partners and members of limited liability companies described above relates to liability arising from their status as such, and is not a general shield against liabilities they may incur due to actions giving rise to any independent basis for liability. Moreover, in the case of both the partnership and limited liability company, all amounts distributed to investors may be clawed back in certain bankruptcy or fraudulent conveyance scenarios to pay partnership liabilities unless otherwise agreed in the organisational document. In addition, courts may (though rarely) apply a doctrine similar to "piercing the corporate veil" in the context of corporations to find limited partners or members liable for partnership or company debts or obligations, in cases of actual fraud. In no event would an investor be liable for more than the amounts contributed by it and amounts distributed to it.

2.3 What are the principal legal structures used for managers and advisers of Alternative Investment Funds?

Fund sponsors may control the fund and receive compensation solely through the general partner (or equivalent governing body) of the fund vehicle. However, they often choose to divide this role between the general partner and a separate vehicle, usually called the "manager". The manager, acting pursuant to a management agreement with the fund, manages the fund's day-to-day operations, and often enters into transactions on behalf of the fund pursuant to a power of attorney. These services are provided in return for a fee, typically calculated as a percentage of commitments, capital contributed to the fund, net asset value of the fund or some combination thereof. The general partner retains ultimate control of the management of the fund delegated to the manager, and receives some share of the fund's profit in the form of an allocation or distribution, commonly referred to as an "incentive allocation", "carried interest" or "promote". The general partner often also serves as the vehicle through which the sponsor contributes capital to the fund.

The decision to bifurcate the sponsor's role and compensation as between the general partner and the manager results from the interplay of various liability and tax considerations. A general partner of a fund organised as a partnership is likely to face greater exposure to liability than a manager providing services pursuant to contract due to the general partner's unlimited liability for the debts and obligations of the partnership, as well as the liabilities associated with any duties and undertakings owed by the general partner to limited partners (for example, the general partner owes a duty of good faith and fair dealing to the limited partners under Delaware law but does not owe a fiduciary duty to them if the partnership agreement so states). This fact will often lead sponsors to seek to cordon off fund-specific liability by establishing a separate general partner for each fund or fund complex, while maintaining one manager entity to provide common infrastructure such as employment and service provider contracts and ownership of intellectual property. General partner liability also militates in favour of compensating the sponsor uniquely through fee payments to the manager. However, structuring compensation as an allocation of fund profits to the general partner of the fund partnership allows the profits to retain their tax character in the hands of the sponsor, which profits may include capital gains and/or dividend income (members of Congress have proposed legislation that would take away the favourable tax treatment of such profit allocations). Moreover, the activities delegated to the manager may subject its fee income to state or local tax (for example, the Unincorporated Business Tax in New York City), and this provides the additional advantage of a profits allocation to the general partner.

The Delaware limited liability company is the form used most often for general partners and managers. This form offers the benefits of the Delaware limited partnership referenced above under question 2.1, including the ability to elect pass-through tax treatment. In addition, a limited liability company can be governed by a managing member or board of directors that, unlike a general partner, is not by virtue of its status exposed to the entity's debts and obligations. Certain sponsors still use an older form of entity called a "subchapter S corporation", which also offers limited liability and pass-through tax treatment. However, this older form has generally fallen out of use because it imposes numerous restrictions, including that only one class of stock may be issued and the holders typically cannot be other entities. The limited liability company by contrast permits great variation in the treatment of members, on an individual or class basis, both as to governance and economic rights. For example, control may be given solely to senior management, and the share of profits and terms governing vesting of profits interests may easily be varied as among members according to any number of criteria.

2.4 Are there any limits on the manager's ability to restrict redemptions in open-ended funds or transfers in open-ended or closed-ended funds?

"Open-ended" in the United States is a term for registered investment companies under the Investment Company Act. Private investment funds are not open-ended as they all restrict redemption to a greater or lesser degree varying from hedge-style (e.g., monthly) to private-equity-style (no redemptions absent special situations). No restrictions are imposed by generally applicable law on the ability of sponsors of private investment funds to restrict the liquidity of an investor's interest in a private investment fund by restricting frequency or volume of redemptions, withdrawals or transfers.

Both hedge-style and private-equity-style investment funds usually do not permit transfers to unaffiliated parties without sponsor consent on a case-by-case basis due, among other things, to the need to assure compliance with the regulatory requirements noted directly below.

2.5 Are there any legislative restrictions on transfers of investors' interests in Alternative Investment Funds?

If in connection with issuance as part of a distribution (for example, by an underwriter purchasing interests in the fund and reselling them through its distribution channels), transfers could result in disqualification of the fund's issuance being exempted from the otherwise applicable requirement to register issuances of securities with the SEC. Similarly, if the securities were issued abroad in reliance on the registration exemption under the SEC's Regulation S, transfers resulting in the interests coming to rest in the United States could result in disqualification from that exemption. In addition, the sponsor must ensure that transfers do not result in 2,000 or more investors holding interests in the fund in order to avoid a requirement to register the fund's securities under the U.S. Exchange Act of 1934 (the limit was fewer than 500 until it was raised to 2,000 under the Jumpstart Our Business Startups Act ("JOBS Act")). If the fund chooses to avoid registration and regulation as an investment company under the Investment Company Act by relying on the Section 3(c)1 exclusion described in question 1.3 above and having fewer than 100 U.S. beneficial owners, it must also ensure that transfers do not result in exceeding that limit. Otherwise, it would need to come within another investment company registration exemption available for funds, such as the exemption for funds whose investors are all "qualified purchasers" (generally, individuals owning $5 million or more in investments, institutions owning and investing on a discretionary basis $25 million or more in investments and directors, officers and certain other "knowledgeable employees" of the fund or its affiliates). Finally, depending on the precise circumstances of the fund, it may want to restrict transfers in order to ensure that it avoids treatment as a "publicly traded partnership", which could subject it to entity-level U.S. federal income taxation.

3 Marketing

3.1 What legislation governs the production and offering of marketing materials?

Section 10(b), the general antifraud provision of the Exchange Act, permits the SEC to adopt rules that prohibit any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities. Pursuant to such authority, the SEC adopted Rule 10b-5, which generally prohibits the use of any "device, scheme, or artifice to defraud", and which creates liability for any misstatement or omission of a material fact. Rule 10b-5 and the other Exchange Act antifraud rules have a broad scope of applicability, which encompasses the marketing of Alternative Investment Funds. Alternative Investment Fund marketing is also regulated by the Advisers Act, specifically the general antifraud provisions set forth in Section 206 and the rules promulgated thereunder. The SEC has generated layers of additional Advisers Act marketing guidelines through various means, including no-action letters and enforcement actions against advisers. The Advisers Act regulations and the additional guidelines articulated by the SEC collectively form a complex and non-intuitive framework of detailed requirements that extends across all aspects of Alternative Investment Fund marketing. Care should be taken to avoid conflating the Advisers Act regulations with the Exchange Act antifraud provisions. For example, in contrast to Rule 10b-5, the Advisers Act regulations are not limited to situations involving the purchase or sale of a security. To the extent that an adviser's communications with an investor are outside of the federal securities laws, they remain subject to common-law and state securities law prohibitions against fraud.

3.2 What are the key content requirements for marketing materials, whether due to legal requirements or customary practice?

The communications of all advisers, whether or not they are registered with the SEC, are subject to the general antifraud provisions of Section 206 of the Advisers Act, which prohibit advisers from engaging in any act, practice, or course of business which is fraudulent, deceptive or manipulative. In addition, the Supreme Court in *SEC v. Capital Gains Research Bureau, Inc.* (75 U.S. 180, 186 (1963)) stated that an adviser, as a fiduciary, has "an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts', as well as 'an affirmative obligation' 'to employ reasonable care to avoid misleading'... clients". The duty of full and fair disclosure is especially important when an adviser's interests may conflict with those of its clients. An adviser is required to make appropriate disclosure to clients regarding any facts that may affect the adviser's independence, including situations that involve a potential conflict of interest. An adviser may be found to have violated Section 206 in cases where the prohibited conduct was unintentional.

Advisers to Alternative Investment Funds are also subject to Rule 206(4)-8 of the Advisers Act, which defines fraud to include certain conduct not commonly considered fraudulent. Rule 206(4)(8) deems it to constitute a fraudulent, deceptive or manipulative act, practice or course of business within the meaning of Section 206 for any registered or unregistered adviser to a pooled vehicle to (a) make any untrue statement of material fact, (b) omit to state a material fact necessary to make a statement not misleading, or (c) otherwise engage in any other fraud on investors or prospective investors in the pooled investment vehicle. The SEC does not have to establish scienter on the part of an adviser in order to bring an enforcement case specifically for fraud. Even an unintentional violation of the substantive provisions of Rule 206(4)-8 that occurs due to negligence would be deemed to constitute fraud within the meaning of Section 206. For example, if an adviser inadvertently and in good faith neglected to include a material fact necessary to make its offering memorandum not misleading, the SEC could bring an enforcement case for fraud against the adviser under Rule 206(4)-8.

In addition to the foregoing antifraud provisions, Rule 206(4)-1 of the Advisers Act specifically prohibits an adviser that is registered or required to be registered with the SEC from certain practices that the SEC considers to be misleading or likely to be misleading. Rule 206(4)-1 prohibits including in an advertisement any of the following: (a) direct or indirect references to a testimonial of any kind concerning the adviser or concerning any advice, analysis, report or other service it has rendered; (b) direct or indirect references to past specific recommendations by the adviser that were or would have been profitable to any person, unless the advertisement sets out or offers to furnish a detailed list of all recommendations made within the immediately preceding period of not less than one year, and includes certain disclaimers; (c) any direct or indirect representation that any graph, chart, formula or other device being offered (i) can in and of itself determine which securities to buy or sell or when to buy or sell securities, or (ii) will assist any person in making such determinations, without in each case prominently disclosing the limitations thereof and the difficulties with respect to its use; or (d) any statement to the effect that any report, analysis or other service will be furnished free or without charge, unless such materials or services are entirely free and without any direct or indirect condition or obligation.

Rule 206(4)-1 also prohibits an adviser from publishing, circulating or distributing any advertisement that contains any untrue statement, or which is otherwise false or misleading. The foregoing "catch-all" prohibition has generated various no-action letter interpretations by the SEC particularly in connection with the standards and methodology for calculating and presenting past performance and for the construction of model performance results. For example, in Clover Capital Management, Inc. (available October 28, 1986), one of the most important no-action letters regarding advertisements, the SEC identified a wide range of specific practices that would be misleading with respect to the presentation of past performance, including, among other things: (a) failing to disclose the effect of material market or economic conditions on the results portrayed; (b) failing to reflect the deduction of investment advisory fees, brokerage or other commissions, and any other expenses that a client would have paid or actually paid; (c) suggesting or making claims about the potential for profit without also disclosing the possibility of loss; and (d) failing to disclose any material conditions, objectives, or investment strategies used to obtain the performance advertised. In Clover, the SEC also stated that several practices would be misleading with respect to the presentation of model results, including, among other things, (i) failing to disclose the limitations inherent in model results, and (ii) failing to disclose if any of the securities or strategies reflected in a model portfolio do not relate, or relate only partially, to the services currently offered by the adviser.

The standards set forth in Clover are just part of a broader set of guidelines that has been created by the SEC with respect to the interpretation of the "catch-all" provision and the other requirements of Rule 206(4)-1. Although a summary of the Rule 206(4)-1 guidelines is beyond the scope of this article, any adviser that is subject to the U.S. advertising rules must become familiar with all aspects of the SEC's requirements. In addition, advisers should be mindful that SEC no-action letters generally advise that whether any particular advertisement is false or misleading also depends on the facts and circumstances involved in its use, including: (i) the form as well as the content of the advertisement; (ii) the implications or inferences drawn from the advertisement in its total context; and (iii) the sophistication of the prospective client.

Rule 206(4)-1(b) defines "advertisement" as including "any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication or by radio or television, that offers: (1) any analysis, report, or publication concerning securities, or that is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell; or (2) any graph, chart, formula, or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell; or (3) any other investment advisory service with regard to securities". Any material that promotes advisory services for the purpose of maintaining existing clients or soliciting potential clients to buy those services will typically be considered an "advertisement". Because of the broad definition of "advertisement", advisers should exercise caution before making a determination that any communication with existing or prospective clients falls outside of the definition of advertisement and is not subject to the advertising requirements under Rule 206(4)-1.

3.3 Do the marketing or legal documents need to be registered with or approved by the local regulator?

The SEC does not impose any requirements for registering or approval of the marketing documents of an Alternative Investment Fund. Nor does the SEC generally provide assistance to advisers in determining whether they are in compliance with the advertising rules. However, during any SEC examination of a registered adviser the SEC will often request to view advertising materials distributed by the adviser, along with documentation supporting the claims made in the advertisements. In addition, any inconsistencies between an adviser's advertising materials and its statements made in filings such as its Form ADV and Form PF are likely to attract the attention of the SEC.

3.4 What restrictions are there on marketing Alternative Investment Funds?

Securities sold in the United States (including interests in Alternative Investment Funds) must be registered with the SEC absent an exemption from the registration requirements under the Securities Act. Interests in Alternative Investment Funds are typically sold in the United States pursuant to an exemption from such requirements because registration would subject an Alternative Investment Fund to regulation under the Investment Company Act and to substantive disclosure and reporting obligations. Alternative Investment Fund interests are sold either under the private placement exemption under Section 4(2) of the Securities Act or the safe harbour thereunder contained in Regulation D. Generally, to fall within either exemption, an adviser must adhere to the following requirements: (a) sales only to "accredited investors" as defined under Regulation D; (b) a "reasonable belief" that its investors are accredited; (c) no general solicitation through television, newspapers, the Internet and the like; (d) maintenance of records of all solicitations made in the U.S.; and (e) no interviews or co-operation with the U.S. press or with press likely to be directed into the U.S. The definition of "accredited investors" is discussed in greater detail in question 3.6 below.

With the 2013 adoption of amendments to Rule 506 of Regulation D implementing certain components of the JOBS Act, Alternative Investment Funds gained the ability to employ general solicitations and general advertising to offer their securities without becoming subject to Securities Act registration requirements. However, in order to engage in such activities an issuer is required to take "reasonable" steps to verify that purchasers of its securities are accredited investors. Whether the steps taken by the issuer are "reasonable" is determined based on the particular facts and circumstances of each offering and each purchaser. An issuer making a general solicitation should retain records that document the processes and procedures used to verify that all of its purchasers are accredited investors. To date, Alternative Investment Funds have generally not availed themselves of the opportunity to make general solicitations and use general advertising. Most continue to abide by the pre-existing requirements prohibiting general solicitation.

In order to avoid registration as an "investment company" under the Investment Company Act, Alternative Investment Funds typically rely on one of the exclusions from the definition of an investment company provided by the Investment Company Act that are discussed in question 3.6 below. While under the Investment Company Act these exclusions cannot be relied upon if an Alternative Investment Fund makes a public offering of its securities, the SEC takes the view that with the adoption of the amendments to Rule 506, Alternative Investment Funds may now employ general solicitations and general advertisements without losing the private fund exclusions under the Investment Company Act. The SEC has also confirmed that an offering in the United States under amended Rule 506 involving general solicitation or general advertising will not prevent an issuer from conducting a concurrent offshore offering pursuant to Regulation S under the Securities Act.

An unregistered offering by an Alternative Investment Fund that fails to comply with all aspects of the exemption from the Securities Act's registration requirements will generate rescission rights under state and federal law for each investor at the original purchase price. These rescission rights are exercisable at any time, regardless of performance, with the adviser potentially bearing the economic risks involved.

3.5 Can Alternative Investment Funds be marketed to retail investors?

Alternative Investment Funds generally must be sold only to "accredited investors" as defined under Regulation D in order to avoid being required to register under the Securities Act, subject to a 35 investor exception for non-accredited investors.[2] The definition of "accredited investors" is discussed in question 3.6 below.

3.6 What qualification requirements must be carried out in relation to prospective investors?

As noted in the prior section, Alternative Investment Funds generally must be sold only to "accredited investors" in order to avoid being required to register under the Securities Act, subject to a 35 investor exception for non-accredited investors. An "accredited investor" includes: an individual which either has a net worth (taken together with the net worth of any spouse) of $1 million,[3] or in the last two years has had either an annual income of $200,000 or a combined annual income (with spouse) of $300,000 and a reasonable expectation of the same income level in the current year; a bank or other financial institution; a tax-exempt or other entity with assets in excess of $5 million; or any entity in which all such entities' beneficial owners are accredited investors. As noted previously, issuers wishing to avail themselves of the opportunity under amended Rule 506 to make general solicitations and use general advertising must take "reasonable" steps to verify that purchasers of their securities are accredited investors. Issuers who do not make general solicitations and do not use general advertising only need to have a "reasonable belief" that all of their investors are accredited investors.

In addition, Alternative Investment Funds typically avail themselves of the exclusion from the definition of an "investment company" contained in either Section 3(c)(1) or 3(c)(7) of the Investment Company Act (Alternative Investment Funds operating under such exclusions are referred to herein as "3(c)(1) funds" and "3(c)(7) funds", respectively). Alternative Investment Funds whose securities (other than short-term paper) are beneficially owned by no more than 100 persons are exempted from the definition of an investment company under Section 3(c)(1). A "look-through" provision applies in determining the number of beneficial owners for purposes of Section 3(c)(1). In the case of a 3(c)(1) fund investor that itself is both (i) a 10 per cent or greater owner of the voting securities of such 3(c)(1) fund, and (ii) a registered investment company, a 3(c)(1) fund, a 3(c)(7) fund, or an owner that would have to register were it organised under U.S. law, then the 3(c)(1) fund must "look through" to such investor's underlying security holders for the purposes of calculating its number of owners. In addition, a 3(c)(1) fund must "look through" any investing entity that was formed for the purpose of investing in the 3(c)(1) fund. It should also be noted that under the Advisers Act a registered investment adviser may not charge performance fees (typically measured based on the amount of both realised and unrealised gains and losses) in connection with an Alternative Investment Fund unless its investors are deemed to be "qualified clients" capable of bearing the risks associated with performance fee arrangements. Qualified client status requires that net worth or assets under management meet certain dollar thresholds that are generally higher than the thresholds required to be an accredited investor. Accordingly, 3(c)(1) funds that charge performance fees must ensure that their investors are qualified clients in addition to being accredited investors.

For an Alternative Investment Fund to qualify as a 3(c)(7) fund, each investor must be a qualified purchaser or knowledgeable employee. Under the Investment Company Act, qualified purchasers include: (a) any natural person that owns not less than $5 million in "investments" (as defined by the SEC); (b) any company directly or indirectly owned entirely by two or more closely related natural persons, their estates or foundations, charities, or trusts formed by or for their benefit that owns not less than $5 million in "investments"; (c) any person, acting for its own account or the accounts of other qualified purchasers, that in the aggregate owns and invests on a discretionary basis not less than $25 million in "investments"; (d) any other trust not formed for the specific purpose of acquiring the 3(c)(7) fund's securities and as to which both the person with investment discretion with respect to the trust and each of the contributors is a qualified purchaser under (a), (b) or (c) above; (e) any person who received securities of a 3(c)(7) fund as a gift or bequest, or due to an involuntary event (such as death, divorce or legal separation) from a qualified purchaser; and (f) any entity in which all beneficial owners of all securities issued are qualified purchasers. Section 3(c)(7) does not "look through" its investors, provided that the investors were not formed for the purpose of making the investment. A 3(c)(7) fund may have an unlimited number of investors without having to register under the Investment Company Act. In practice, however, onshore 3(c)(7) funds typically stay below 499 total investors and offshore 3(c)(7) funds typically stay below 1,999 U.S. investors (with unlimited non-U.S. investors) in order to remain within certain exemptions from Exchange Act registration.

3.7 Are there additional restrictions on marketing to public bodies such as government pension funds?

Some jurisdictions have so-called "pay-to-play" laws which prohibit a corporation from entering into business arrangements or contracts with certain governmental entities if the corporation, its PAC, its affiliates, and in many cases certain covered directors, employees, and their family members (such as spouses or children) make or solicit political contributions in that jurisdiction.[4] These bans on government contracting could last up to five years in some cases. In some jurisdictions, a contribution by a covered donor does not trigger a ban on government contracts but rather requires such contractor to report contributions made by its covered donors. Directors and employees individually making or soliciting political contributions can under many of these laws automatically trigger legal liability for the company. Thus, to address these laws, a company will have to institute a policy pre-clearing or prohibiting director and employee contributions. The question is how broadly to apply such policy.

Applying a ban on contributions too broadly can have implications under applicable labour laws.

Rule 206(4)-5 under the Advisers Act and the related recordkeeping rules in Rule 204-2 provide one example of such a pay-to-play restriction, in this case specifically restricting political activity by investment advisers who do business with government entities, and the use of placement agents. The intent of Rule 206(4)-5 is to remove the connection between political contributions to state and local officials who may have influence over the awarding of government and public pension investment advisory business (i.e., "pay-to-play" practices). This is accomplished by:

- prohibiting advisers from being compensated for investment advisory services provided to a state or local government entity for two years if covered employees of the firm make political contributions to certain officials of that government entity;
- prohibiting solicitation or coordination of political contributions to such officials or certain state or local party committees;
- only allowing employees of the adviser and certain regulated entities to solicit investment advisory business from government entities; and
- requiring advisers to maintain books and records relating to state and local government entity clients, political contributions, use of placement agents, and information relating to covered employees.

Each state and many localities also have lobby laws that impose lobby registration and reporting requirements on persons who contact certain public officials for the purpose of influencing certain governmental decisions or actions. In addition to requiring registration for "traditional" lobbying activity such as lobbying legislation and regulations, the majority of states and numerous localities also require registration for procurement lobbying, including marketing to public bodies or attempting to influence any other non-ministerial official action of the executive branch or any of its agencies.

Each state also has its own gift laws regulating gifts, e.g., meals, entertainment, gift items, transportation, or lodging, given to its state and/or local public officials. Also note that certain local jurisdictions have their own separate gift laws. These laws vary depending on the jurisdiction, and tend to fall into four categories: jurisdictions which: (1) absolutely ban gifts regardless of value; (2) impose dollar limits on gifts – some are per occasion and some are per time period; (3) prohibit gifts that may reasonably tend to influence an official; and (4) only restrict gifts which may be problematic under a bribery standard.

3.8 Are there any restrictions on the use of intermediaries to assist in the fundraising process?

Exchange Act section 3(a)(4) defines the term "broker" to mean "any person engaged in the business of effecting transactions in securities for the accounts of others". The Exchange Act further requires that brokers be registered as such with the SEC. In addition, depending on various fact-based circumstances, brokers may have to register with the securities commissions of the states in which they are effecting transactions in securities. Accordingly, when an Alternative Investment Fund is sold, the question should be asked whether the person selling the Alternative Investment Fund is acting as a "broker" and should therefore be registered as such.

However, Rule 3a4-1 under the Exchange Act provides a safe harbour, which deems certain partners, directors, officers, employees, and other agents (collectively, "associated persons") of an issuer not to be brokers. This exemption permits associated persons of an adviser to participate in the sale of the interests of an Alternative Investment Fund provided that certain requirements are met, including, among others, that each person selling interests is not (a) subject to certain statutory disqualifications, (b) directly or indirectly compensated in connection with sales of the Alternative Investment Fund, or (c) currently (and, with respect to certain employees, has not recently been) associated with a registered broker. This exemption is relatively narrow and requires attention to the precise circumstances surrounding the sale of the Alternative Investment Fund's interests. For example, in order to comply with the exemption's requirement that associated persons not be compensated in connection with sales of the Alternative Investment Fund's interests, an adviser that is contemplating a bonus for an associated person must consider whether that bonus may be correlated with, or may even have the appearance of being correlated with, such associated person's sales of the interests of the Alternative Investment Fund.

The safe harbour offered by Rule 3a4-1 is especially significant given that the use of a broker who should be, but is not, registered, to sell interests of an Alternative Investment Fund can result in substantial sanctions not only for the broker, but also the Alternative Investment Fund and its adviser. Such sanctions could include the granting of rescission rights to investors, such that the relevant investors may recoup the original price of their investment in an Alternative Investment Fund regardless of the current valuation of that holding.

One sometimes encounters the claim that a person who introduces a potential buyer of securities to an issuer is not engaged in the business of effecting transactions in securities for the accounts of others and therefore is merely a "finder" who is not required to register as a broker. However, the circumstances in which a person could be considered a "finder" are extremely rare because the concept of "finder" does not include the normal range of selling activities (e.g., discussions regarding an Alternative Investment Fund and the delivery of an Alternative Investment Fund's offering materials). Consequently, it is unusual to find a person who confines the scope of his activities in such a way as to meet the definition of a "finder". As such, advisers must take precautions to ensure that paid sales agents are properly registered or actually exempt from registration.

Rule 206(4)-3 under the Advisers Act prohibits an adviser that is required to be registered under the Advisers Act from directly or indirectly paying a cash fee to a solicitor with respect to solicitation arrangements unless certain additional conditions are met. Among the requirements is an agreement by the solicitor to provide the client with a copy of the investment adviser's Form ADV Part 2A and a separate written solicitor disclosure.[5] In addition, Form ADV also requires that an adviser disclose that it pays solicitation fees and describe the fee arrangements.

3.9 Are there any restrictions on the participation by financial institutions in Alternative Investment Funds (whether as sponsors or investors) arising from the 2008 financial crisis?

In December 2013, five U.S. financial regulatory agencies adopted final regulations implementing the Volcker Rule, a provision of the Dodd-Frank Act that prohibits banking entities (including asset manager subsidiaries of such banking entities) from organising and offering, or investing in, hedge funds or private equity funds. Despite the ban on investments in such funds, however, the Volcker Rule allows banking entities to continue to sponsor and invest in covered funds, subject to certain exemptions.

The primary exemption available to banking entities is the "permitted funds exemption". In order to qualify for the permitted funds exemption a banking entity must satisfy the following conditions:

(i) the banking entity must provide *bona fide* trust, fiduciary, investment advisory or commodity trading advisory services;

(ii) the fund must be organised and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity;

(iii) the banking entity must limit (a) its ownership of the fund to less than 3 per cent of the fund's ownership interests, and (b) its aggregate ownership in all covered funds to less than 3 per cent of the banking entity's Tier 1 capital;

(iv) the banking entity must comply with the restrictions governing relationships with covered funds under Section 16 of the proposed regulations;

(v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests;

(vi) the fund, for corporate, marketing, promotional or other purposes, may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and may not use the word "bank" in its name;

(vii) no director or employee of the banking entity may take an ownership interest in the covered fund except for any director or employee who is directly engaged in providing investment advisory or other services to the covered fund; and

(viii) the banking entity must clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund certain enumerated disclosures and comply with any additional rules of the appropriate agencies designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.

The Volcker Rule became effective on April 1, 2014; however, the Federal Reserve has extended the conformance period for complying with the Volcker Rule for all banking entities until July 21, 2015. During the conformance period, a banking entity must engage in good faith efforts, appropriate for its activities and investments, to enable the banking entity to conform its activities and investments to the requirements of the final rule by July 21, 2015. The Federal Reserve noted that a banking entity should not expand its activities or make investments during the conformance based on an expectation that the conformance period might be extended beyond July 21, 2015. Banking entities subject to the Volcker Rule may request up to two one-year extensions for compliance, plus one additional extension of up to five years for certain illiquid funds.

4 Investments

4.1 Are there any restrictions on the types of activities that can be performed by Alternative Investment Funds?

Limitation on Insider Trading

Federal and state securities laws prohibit Alternative Investment Funds from trading securities – including equity and debt securities and derivative instruments – based on "inside information" or "material, nonpublic information". These laws also prohibit the distribution of inside information to others who may use that knowledge to trade securities (also known as "tipping").

Information is material where there is a substantial likelihood that a reasonable investor would consider that information important in making his or her investment decisions. Generally, this includes any information the disclosure of which may have a substantial effect on the price of a company's securities. No simple test exists to determine when information is material; assessments of materiality involve a highly fact-specific inquiry.

Material information often relates to a company's financial results and operations, including, for example, dividend changes, earnings results, changes in previously-released earnings estimates, significant merger or acquisition proposals or agreements, major litigation, liquidity problems, and extraordinary management developments.

Material information also may relate to the market for a company's securities. Pre-publication information regarding reports to be published in the financial press also may be material.

Information is "public" when it has been disseminated broadly to investors in the marketplace. For example, information is public after it has become available to the general public through a public filing with the SEC or some other government agency, a news reporting service or publication of general circulation, and after sufficient time has passed so that the information has been disseminated widely.

4.2 Are there any limitations on the types of investments that can be included in an Alternative Investment Fund's portfolio whether for diversification reasons or otherwise?

Generally, advisers advising Alternative Investment Funds are obligated to cause such funds to invest in the types of investments that are consistent with such fund's investment objective, as disclosed in such fund's offering materials. In addition, certain other restrictions on the types of investments that can be included in an Alternative Investment Fund's portfolio apply, as discussed below.

Investments in Regulated Industries

A variety of federal and state laws place limits on ownership of the securities of certain companies. Most of these federal and state laws apply to companies in highly regulated industries. The laws are designed to prevent a single person or group from acquiring an influential or controlling position in a company. These laws may require prior consent of a regulator before the securities can be purchased, and, for purposes of determining ownership or control, an investment adviser may be required to aggregate the holdings of all accounts over which it exercises investment discretion along with any proprietary accounts and accounts of its principals. Some of the types of issuers where applicable laws place restrictions include:

- public utility companies or public utility holding companies;
- bank holding companies;
- owners of broadcast licences, airlines, railroads, water carriers and trucking concerns;
- casinos and gaming businesses;
- defence-related industries, including the Committee on Foreign Investment in the United States ("CFIUS") review of transactions that could result in control of a U.S. business by a foreign person;
- insurance companies; and
- public service companies (such as those providing gas, electric or telephone services).

In addition, the Hart-Scott-Rodino Anti-Trust Improvements Act of 1976 (the "HSR Act") places notification requirements and waiting periods before transactions subject to the HSR Act may be consummated. The HSR Act is intended to address antitrust concerns, and the notification and waiting periods are designed to allow government officials to review and approve certain transactions. The HSR Act's requirements may be triggered by the proposed acquisition of voting securities and assets of the acquired person having an aggregate value of $50 million (as adjusted). Such an acquisition, however, would be exempt from these requirements of the HSR Act if the acquisition were for investment purposes only and if, as a result of such acquisition, the acquirer would hold 10 per cent or less of the issuer's outstanding voting securities.

Investments in Registered Funds

Although Alternative Investment Funds are not registered under the Investment Company Act, they are nevertheless subject to the restrictions of Sections 12(d)(1)(A)(i) and (B)(i) of that Act. These provisions require that any Alternative Investment Fund and any entity controlled by the Alternative Investment Fund, may not own, in the aggregate, more than 3 per cent of the total outstanding voting securities of any registered open-ended or closed-ended investment company (each, a "Registered Fund"), including money market funds. The 3 per cent limit is measured at the time of investment.

Alternative Investment Funds that invest all of their assets (other than cash) in a Registered Fund pursuant to a master-feeder arrangement, however, are not subject to the restrictions of Section 12(d)(1), provided that the following conditions are met:

- the Alternative Investment Fund's depositor or principal underwriter must be a registered broker-dealer, or a person controlled by a registered broker-dealer; and
- the purchase of Registered Fund shares must be made pursuant to an arrangement whereby the Alternative Investment Fund is required to vote all proxies: (i) in accordance with the instructions of its security holders; or (ii) in the same proportion as the vote of all other shareholders of the Registered Fund.

Finally, Alternative Investment Funds may be permitted to invest in certain registered, exchange-traded funds ("ETFs") beyond the 3 per cent aggregate limit established by Section 12(d)(1). The ETF, however, must have obtained an exemptive order from the SEC that specifically permits investments above 3 per cent by Alternative Investment Funds, and an Alternative Investment Fund's investment in the ETF must meet all terms and conditions contained in the order.

Short Sales

Short selling involves selling securities that may or may not be owned by the seller and borrowing the same securities for delivery to the purchaser, with an obligation to replace the borrowed securities at a later date. "Naked" short selling generally refers to a practice whereby securities are sold short without the seller's owning or having borrowed the requisite securities and therefore may result in a "failure to deliver". Short selling allows the investor to profit from declines in securities prices. A short sale creates the risk of a theoretically unlimited loss, in that the price of the underlying security could theoretically increase without limit, thus increasing the cost to the Fund of buying those securities to cover the short position. There can be no assurance that the security necessary to cover a short position will be available for purchase. Consequently, certain market participants could accumulate such securities in a "short squeeze", which would reduce the available supply, and thus increase the cost, of such securities. Purchasing securities to close out the short position could itself cause the price of the securities to rise further, thereby exacerbating the loss. In order to reduce "failures to deliver" and address certain concerns and abuses associated with naked short selling, the SEC adopted Rule 203(b) of Regulation SHO under the Exchange Act to limit the ability of a broker or dealer to accept short sale orders unless the person entering the order, e.g., the Firm, has already arranged to borrow the security necessary to cover the position or has reasonable grounds to believe the security can be borrowed in time to meet the delivery date. Additionally, Rule 201 of Regulation SHO (the "circuit breaker" rule) limits the ability to execute orders on short sales on certain securities that are not marked "short exempt" (within the meaning of Rule 200(g) of Regulation SHO) and that have declined in value by 10 per cent or more from the prior day's closing price.

SEC Rule 105 of Regulation M under the Exchange Act ("Rule 105") prohibits any "person" from purchasing from a secondary offering of equity securities for cash if the person has effected a short sale in such security during the "Rule 105 Restricted Period", that is, the shorter period beginning: (i) five business days prior to the pricing of the offered securities; or (ii) with the initial filing of the registration statement or other offering document with the SEC and, in each case, ending with the pricing of the offered securities. Generally all Alternative Investment Funds managed by a single adviser would be treated collectively as a "person" for the purposes of Rule 105, unless formal information barriers are adopted that prevent coordination of trading and sharing of information between portfolio managers of different Alternative Investment Funds directly or indirectly.

Further, another possible exception is the "*bona fide* purchase" exception, as defined in Rule 105.

4.3 Are there any restrictions on borrowing by the Alternative Investment Fund?

There are no restrictions on borrowing by the Alternative Investment Funds but the leverage and its attendant risks must be disclosed in the fund's offering materials.

5 Disclosure of Information

5.1 What public disclosure must the Alternative Investment Fund make?

An Alternative Investment Fund that relies on the exemptions from registration under Regulation D of the Securities Act to offer its interests must file a Form D at the time of the first closing of such fund in which U.S. investors participate and must amend it annually for so long as the fund continues to offer its interests. Form D requires disclosure of certain information about the fund, including: the identity of the issuer's executive officers, directors, promoters and other related persons; amounts sold; and any sales commissions paid. Filed Forms D are publicly available online. Furthermore, Alternative Investment Funds are subject to similar filings with states under Blue Sky Laws.

Alternative Investment Funds and their advisers must make certain public filings, including the following, among others:

- SEC Reporting on Ownership of Equity Securities. The Securities Exchange Act requires any person who, directly or indirectly, acquires more than 5 per cent of any class of shares of a domestic public company to file a report with the SEC within 10 days of such acquisitions. Additional reporting is required if a person acquires more than 10 per cent of the shares of a U.S. public company.
- SEC Portfolio Reporting. Any institutional investment manager with investment discretion over US$100 million or more in equity securities at the end of a calendar year must file quarterly reports with the SEC containing position information about the equity securities under the discretion of the fund manager, and the type of voting authority exercised by the fund manager.

- Filings with the Internal Revenue Service.
- Form ADV, the form used by investment advisers to register with the SEC, which requires certain disclosure about:
  - the types of services offered by an investment adviser;
  - the adviser's fee schedule;
  - disciplinary information relevant to the adviser or its employees;
  - conflicts of interest;
  - the educational and business background of management and key advisory personnel of the adviser; and
  - certain information regarding each Alternative Investment Fund managed by the adviser, including each fund's gross asset value, number and nature of beneficial owners, minimum investment or commitment amount, and information pertaining to such fund's auditors, prime brokers, custodians and administrators.

In addition, the SEC has adopted substantial new reporting obligations with respect to Private Investment Funds under Form PF.

Under the new rules, only SEC-registered private fund advisers with at least $150 million in private fund assets under management must file Form PF. Within this group, private fund advisers are divided by size into the following two broad groups with different reporting requirements:

- Large private fund advisers. This includes any adviser with:
  - $1 billion or more in liquidity and registered money market fund assets under management, which must file Form PF quarterly, within 60 days of the end of each fiscal quarter.
  - $1.5 billion or more in hedge fund assets under management, which must file Form PF quarterly, within 15 days of the end of each fiscal quarter.
  - $2 billion or more in private equity fund assets under management, which must file Form PF annually, within 120 days of the end of the fiscal year.

These investment advisers must include more detailed information than smaller investment advisers. The reporting focuses on the following types of private funds that the investment adviser manages:

- Hedge Funds. Large hedge fund advisers must report on an aggregated basis (and not on a position-level basis) information regarding exposures and turnover by asset class and geographical concentration. In addition, for each managed hedge fund having a net asset value of at least $500 million, these advisers must report certain information relating to that fund's exposures, leverage, risk profile and liquidity;
- Liquidity Funds. Large liquidity fund advisers must provide information on the types of assets in each of their liquidity fund's portfolios, certain information relevant to the risk profiles of the funds and the extent to which a fund has a policy of complying with all or certain aspects of the Investment Company Act's principal rule concerning registered money market funds (Rule 2a-7);
- Private Equity Funds. Large private equity fund advisers must respond to questions focusing primarily on the extent of leverage incurred by their funds' portfolio companies, the use of bridge financing and their funds' investments in financial institutions; and
- Smaller private fund advisers. This includes all other private advisers that are not considered large private fund advisers. These investment advisers must file Form PF annually within 120 days of the end of the fiscal year and report only basic information regarding the private funds they advise. This includes information regarding size, leverage, credit providers, investor types and concentration and fund performance and, additionally for hedge funds, fund strategy, counterparty credit risk and use of trading and clearing mechanisms.

5.2 What are the reporting requirements in relation to Alternative Investment Funds?

See question 5.1 above.

5.3 Is the use of side letters restricted?

There are no outright restrictions on the use of side letters. However, advisers to Alternative Investment Funds are subject to fiduciary duties under Section 206 of the Advisers Act and Rule 206(4)-8 under the Advisers Act, which prohibit an adviser from making false or misleading statements of material fact to current and prospective investors or engaging in other fraudulent conduct with respect to a fund's investors. Therefore, to the extent side letters provide investors with preferential terms that may have an adverse effect on other investors in the Alternative Investment Fund, the Alternative Investment Fund should make the disclosures reasonably necessary to give other investors the ability to assess the impact of such side letters on their investment, if any. Such preferential terms include any modifications to the voting or control rights, preferential liquidity rights, and terms that materially alter the investment programme. In addition, to the extent an Alternative Investment Fund agrees to provide any additional material information to an investor pursuant to a side letter, such Alternative Investment Fund should take steps to disclose such information to all investors simultaneously.

6 Taxation

6.1 What is the tax treatment of the principal forms of Alternative Investment Funds?

Most U.S.-sponsored private investment funds are classified as partnerships, which are transparent for U.S. federal income tax purposes. If the fund will make significant non-U.S. equity investments, forming the fund as a non-U.S. entity in a tax-neutral jurisdiction, such as the Cayman Islands, minimises the likelihood that the portfolio investments will be subject to the anti-deferral controlled foreign corporation ("CFC") rules, which can require taxable U.S. investors to include their share of the portfolio company's earnings in income in advance of the receipt of cash attributable to such income.

As noted above, in order to accommodate structures that take into account the tax considerations relevant to different categories of investors, private investment funds are often established with several "parallel" or "mirror" funds that invest in a side-by-side manner. This permits each parallel fund to structure its holding of particular portfolio investments or categories of investments in the manner that is optimal for the investors in that parallel fund. For example, certain U.S. tax-exempt investors are subject to U.S. federal income tax on "unrelated business taxable income", which includes income treated as debt-financed ("UBTI"). U.S. tax-exempt investors may invest in a parallel fund that structures any investments that would give rise to UBTI through investments in corporations, REITs or other non-transparent entities that "block" income that might subject them directly to income tax or reporting requirements in the U.S. Similarly, a parallel fund established for non-U.S. investors will allow the fund to "block" any investments that would result in U.S. tax and reporting obligations for those investors if held on a flow-through or transparent basis by making such investments through corporations, REITS or other non-transparent entities.

Hedge funds, by contrast, often employ a "master-feeder" type of structure. In this structure, investors subscribe for interests in "feeder funds" that in turn all invest in one "master" fund that holds all investments. Typically, U.S. taxable investors invest in an onshore feeder that is classified as a partnership (and thus transparent) for U.S. federal income tax purposes, while foreign and U.S. tax-exempt investors invest through an offshore feeder classified as a non-U.S. corporation for U.S. tax purposes and organised in a tax-neutral jurisdiction. The offshore feeder's corporate classification "blocks" any UBTI that would result from leverage used by the master fund. The feeder's corporate status also ensures that the feeder, rather than the investors, would be subject to any U.S. tax reporting obligations should they arise.

The master fund is often classified as a partnership for U.S. federal income tax purposes. If classified as a corporation, provided it is formed in a non-U.S. jurisdiction, the fund generally will not be subject to entity-level tax in the U.S. so long as the fund is not treated as engaged in a U.S. trade or business in the U.S. as discussed below. U.S. taxable investors in the onshore feeder generally will include their share of the fund's income and gains in income on a current basis (much like the tax treatment of a partnership) under the passive foreign investment company ("PFIC") rules. (Although PFIC tax treatment is similar to that of a partnership, certain differences may be important, including that losses do not flow through to investors and expenses of the fund are not subject to the miscellaneous itemised deduction limitations that apply to U.S. taxable individual investors.)

U.S. managers of investment funds with non-U.S. investors typically take steps to ensure that fund investments qualify under a safe harbour for trading in stocks or securities for the fund's own account, which ensures that the fund will not be subject to tax in the U.S. despite the manager's activities in the U.S. on behalf of the fund. Likewise, managers typically monitor investments to avoid taxation under the "FIRPTA" rules that can apply if the fund invests in U.S. real property (or entities holding substantial U.S. real property that constitute United States real property holding companies ("USRPHCs")). These constraints may pose additional considerations in structuring investments or sales of fund assets. For example, investments in newly originated loans or debt instruments may not qualify for the trading safe harbour. Likewise, investments in USRPHCs would subject the fund to U.S. federal income tax and reporting obligations unless the investment was in the form of debt or 5 per cent or less of the equity of a publicly traded company.

Private investment funds with U.S. tax-exempt or non-U.S. investors often take additional steps to structure investments and sales of assets in a manner that avoids triggering U.S. tax for non-U.S. and tax-exempt investors, as noted above.

6.2 What is the tax treatment of the principal forms of investment manager/adviser?

U.S. sponsors typically form the fund investment manager/advisor as an entity classified as a partnership for U.S. federal income tax purposes. As noted above, the sponsors often form separate vehicles to serve as the manager and the fund general partner so that the general partner is not subject to certain state or local franchise taxes (such as the Unincorporated Business Tax in New York City) with respect to the profits it receives in the form of a "carried interest" or "promote" from the fund. Under current U.S. federal income tax law, profits allocated to the general partner from the fund retain their tax character when they flow through to the sponsor's equity owners, which profits may include capital gains and/or dividend income. The holder of a partnership interest generally recognises capital gain upon a sale of his interest in the partnership (except to the extent attributable to the value of certain inventory items). Thus, under current law, if the equity owners of the fund manager and fund general partner sell their interests in the manager and general partner entities, they would generally recognise capital gain on the sale. (Members of the U.S. Congress and the Administration have proposed legislation in the past that would take away at least some portion of the favourable tax treatment of such profits allocations and, potentially, gain on sale of an interest in the manager and/or general partner.)

Sponsors may utilise different and more complex structures where key employees or other service providers are located in both U.S. and non-U.S. jurisdictions. These structures may involve separate vehicles for U.S. versus non-U.S. service providers and/or sub-advisory agreements between the main fund advisor and sub-advisors operating in different jurisdictions. Transfer pricing considerations are relevant to ensuring that the economic arrangements among the different vehicles, the advisor and the sub-advisors minimise the likelihood of double taxation.

6.3 Are there any establishment or transfer taxes levied in connection with an investor's participation in an Alternative Investment Fund or the transfer of the investor's interest?

Provided the fund is structured to ensure that non-U.S. investors are not treated as engaged in a U.S. trade or business (including by way of their direct investment in a partnership or other transparent entity that is treated as so engaged) and that the fund's investments are not subject to tax under FIRPTA, no U.S. federal income tax or transfer tax should apply to a non-U.S. investor's participation in, or sale or transfer of its interests in the fund. Likewise, U.S. tax-exempt investors should not be subject to U.S. federal income tax or transfer tax provided that their investment is structured in a manner that "blocks" UBTI (for example, investment in the offshore feeder of a master-feeder hedge fund structure or investment in a parallel private investment fund that structures investment to prevent UBTI) and that an investor does not finance its investment in the fund with debt.

Investors (or the fund itself) may be subject to certain U.S. withholding taxes as described below.

Typically, funds will endeavour to structure their investments so that the fund is not treated as having a permanent establishment in the jurisdiction by reason of its investments or activities in that jurisdiction. Non-U.S. jurisdictions may impose withholding or transfer taxes on the fund or fund investors.

6.4 What is the tax treatment of (a) resident and (b) non-resident investors in Alternative Investment Funds?

U.S. Taxable Investors. Typically, U.S. taxable investors invest in a fund vehicle that is classified as a partnership (and thus transparent) for U.S. federal income tax purposes. U.S. taxable investors generally will include their share of the fund's income and gains in income on a current basis. If instead the fund is classified as a corporation, U.S. taxable investors generally will include their share of the fund's income and gains in income on a current basis (much like the tax treatment of a partnership) under the PFIC rules. (Although PFIC tax treatment is similar to that of a partnership, certain differences may be important, including that losses do not flow through to investors and expenses of the fund are not subject to the miscellaneous itemised deduction limitations that apply to U.S. taxable individual investors.)

Non-U.S. Investors. Provided the fund is structured to ensure that non-U.S. investors are not treated as engaged in a U.S. trade or business (including by way of their direct investment in a partnership or other transparent entity that is treated as so engaged) or subject to state and local tax and that the fund's investments are not subject to tax under FIRPTA, no U.S. federal income tax or reporting obligations should apply to a non-U.S. investor's participation in, or sale or transfer of its interests in the fund.

Non-U.S. investors (or, in hedge fund master-feeder structures, the offshore feeder fund) may be subject to U.S. withholding tax at a 30 per cent rate on their share of interest, dividends, dividend-equivalents and other fixed or determinable annual or periodical ("FDAP") income from sources within the U.S. Certain interest is exempt from this withholding tax.

Separately, under the Foreign Account Tax Compliance Act ("FATCA"), certain foreign financial institutions, including most investment funds and non-U.S. custodians ("FFIs"), will be subject to a 30 per cent withholding tax on U.S. source dividends, interest and certain other payments, and, starting in 2017, on the gross proceeds from the sale of equity interests or debt issued by U.S. issuers and possibly other payments, unless the institution enters into an agreement with the U.S. Internal Revenue Service (the "IRS") to report certain information regarding beneficial ownership by U.S. persons and complies with other requirements (or, where the U.S. has entered into an intergovernmental agreement with a relevant jurisdiction (an "IGA"), the institution complies with requirements under the IGA, which will entail reporting information regarding beneficial ownership either to the IRS or the taxing authority in the relevant jurisdiction). A non-U.S. investor that is considered to be an FFI under FATCA or a relevant IGA may be subject to U.S. withholding tax unless it complies with applicable requirements.

6.5 Is it necessary or advisable to obtain a tax ruling from the tax or regulatory authorities prior to establishing an Alternative Investment Fund?

No tax ruling is typically obtained in the U.S., although tax counsel to private investment funds may render an opinion to the sponsor, based on customary assumptions and representations from the sponsor, on the expected U.S. federal income tax classification of the fund.

Funds may make certain non-U.S. investments in the form of investments in special purpose vehicles in non-U.S. jurisdictions in order to allow the funds to obtain the most efficient non-U.S. tax treatment of certain investments. In this case, it may be advisable to seek a tax ruling from the relevant tax authorities confirming the intended tax treatment.

6.6 What steps are being taken to implement the US Foreign Account and Tax Compliance Act 2010 (FATCA) and other similar information reporting regimes?

After several years of delays, financial institutions saw the Foreign Tax Compliance Act (FATCA) finally take effect on July 1, 2014. Congress enacted FATCA as part of the HIRE Act in 2010 in order to stop U.S. taxpayers from evading U.S. taxes through undisclosed offshore accounts and investments. FATCA requires foreign financial institutions – including most non-U.S. investment funds and other collective investment vehicles – to report information about the holdings of U.S. taxpayers or face 30 per cent withholding on certain payments they receive. FATCA also imposes new withholding and reporting obligations on U.S. funds.

The U.S. Treasury Department and IRS delayed FATCA's effective date several times in order to give institutions more time to prepare to comply with FATCA's sweeping requirements as well as to allow the Treasury and IRS to finalise detailed regulations and forms necessary for FATCA's implementation. The extra time also allowed the IRS to put into place its Internet web portal, which each foreign financial institution must use to register and receive a global intermediary identification number ("GIIN") needed to evidence FATCA compliance to payors.

Shortly before July 1, the Treasury Department and IRS released welcome transition rules. Thus, although FATCA took effect July 1, under the transition rules, certain due diligence, reporting and withholding requirements do not take effect until 2015 or 2016. In addition, the IRS said that, for purposes of FATCA enforcement, it will consider 2014 and 2015 transition years and will take into account the extent to which institutions have made good faith efforts to comply.

Importantly, in the time leading up to July 1, the Treasury Department worked to negotiate intergovernmental agreements (IGAs) with a number of different countries implementing FATCA for institutions in those jurisdictions. The IGAs address local law impediments, such as bank secrecy and data protection laws, that would prevent institutions in those countries from fully complying with FATCA. The Treasury and IRS have allowed countries that have agreed in substance to an IGA but have not yet entered into one to be treated as having an IGA in effect, thereby allowing financial institutions in those jurisdictions to be considered FATCA-compliant. Meanwhile, the Treasury Department continues to work to conclude additional IGAs. Institutions in IGA jurisdictions will ultimately be governed by laws enacted by their local jurisdictions to implement FATCA. Some countries have enacted FATCA laws or at least guidance in draft form, while many others have not yet done so.

Finally, the OECD has released a common reporting standard (CRS) for Automatic Exchange of Financial Account Information and a model Competent Authority Agreement (CAA) modelled on FATCA. Under the CRS, countries will annually obtain financial information from financial institutions in their jurisdictions and will then automatically exchange that information with their exchange partner countries. Countries wishing to participate will need to translate the CRS into domestic law and enter into a CAA with each exchange partner country. The CRS will supplement existing exchange of information arrangements (e.g. tax treaties and the OECD Multilateral Convention on Mutual Assistance in Tax Matters).

6.7 Are there any other material tax issues?

The foregoing is a general summary of certain U.S. federal income tax issues. A private investment fund may encounter other material U.S. tax issues depending on the relevant facts and circumstances.

7 Reforms

7.1 What reforms (if any) are proposed?

The Dodd-Frank Act represented a significant change in the regulatory regime governing Alternative Investment Funds and their advisers. Prior to the Dodd-Frank Act, many investment advisers to Alternative Investment Funds were exempt from registration under the Advisers Act and as a result did not have to comply with the reporting and compliance obligations that apply to registered investment advisers. However, as a result of the Dodd-Frank Act's changes to the Advisers Act (described in question 1.2), nearly all advisers to Alternative Investment Funds that are offered or sold in the United States are either required to be registered with the SEC (or state regulatory agencies) or are "exempt reporting advisers" and required to file annual reports with the SEC.

Additionally, the Dodd-Frank Act led to the creation of Form PF, the SEC's and CFTC's systemic risk reporting form described in question 1.3. Form PF requires registered investment advisers with over $150 million in private fund assets under management to report detailed portfolio-level information about the private funds they advise. Unlike Form ADV, Form PF is a confidential form that is reported only to the SEC and CFTC, and may be shared with other regulatory agencies and with Congress. The information contained in Form PF is designed, among other things, to assist the U.S. financial regulators in their assessment of systemic risk in the U.S. financial system.

These recent changes have increased the compliance obligations applicable to advisers. They have also given the SEC a great deal more information about the Alternative Investment Funds industry in the United States.

Separately, beginning in 2007, members of the U.S. Congress have proposed legislation changing the treatment of profits interests or "carried interests" in certain partnerships, and the Obama Administration has suggested similar proposals. The proposals would treat profit allocations to service providers in certain partnerships as ordinary income, meaning that carried interests received by the general partner of an investment fund would no longer retain the character of the underlying profits. The proposals would also tax as ordinary income the capital gain realised on the sale of an interest in the partnership. Representative Camp recently put forth a discussion draft of proposed tax legislation including a carried interest proposal which is arguably more narrowly targeted at private equity and venture capital funds, although it could still apply to other funds and potentially their advisers. It is uncertain whether, or in what form, any carried interest proposal would be enacted.

Endnotes

1. For these purposes a "private fund" is any fund that would be an investment company under the Investment Company Act but for Sections 3(c)(1) or 3(c)(7) of that Act.
2. Certain barriers to accepting non-accredited investors exist. Rule 506 requires that non-accredited investors have sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment. Non-accredited investors are unlikely to be "qualified clients" that are eligible to be charged performance fees. In addition, Alternative Investment Funds that wish to avail themselves of the opportunity to make general solicitations following the implementation of the amendments to Rule 506 of Regulation D will be unable to accept non-accredited investors.
3. Net worth calculation includes personal property and other assets, provided that the value of the individual's primary residence, as well as the amount of indebtedness secured by the primary residence up to the fair market value of the primary residence, is excluded, but (i) indebtedness secured by the primary residence in excess of the value of the primary residence is considered a liability, and (ii) if the amount of indebtedness secured by the primary residence outstanding at the time of the individual's purchase of the interests in an Alternative Investment Fund exceeds the amount outstanding 60 days before such time, other than as a result of the acquisition of the primary residence, the amount of such excess is considered a liability.
4. Providing gifts and entertainment to public officials triggers pay-to-play restrictions in some jurisdictions as well. Please also note that a number of states and entities have imposed restrictions or outright bans on investment advisers' use of "placement agents" as intermediaries when contacting public pension funds.
5. The solicitor disclosure is required to include: (a) the name of the solicitor; (b) the name of the adviser; (c) the nature of the relationship between the solicitor and the adviser; (d) a statement that the solicitor will be compensated by the adviser for the referral; (e) the terms of such compensation arrangement including a description of the fees paid or to be paid to the solicitor; and (f) the amount that will be charged in addition to the investment advisory fee and the differential attributable to such a solicitor arrangement.

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