Chapter XX

UNITED STATES

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I OVERVIEW OF RECENT ACTIVITY

In response to the financial crisis, Congress adopted the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act). The Dodd-Frank Act was intended to improve the functioning of the financial markets, enable enhanced monitoring of systemic risk and provide better investor protections. However, much of the Dodd-Frank Act was not self-executing and required various regulatory agencies to adopt rules implementing its provisions. As a result, the majority of regulatory changes over the past year affecting asset managers related to the continued implementation of the Dodd-Frank Act by regulators. In addition to the changes mandated by the Dodd-Frank Act, regulators have also independently adopted or proposed other regulatory reforms to achieve the goals of the Dodd-Frank Act. The most significant changes affecting asset managers are described in more detail in Section V, *infra*.

The Dodd-Frank Act is widely regarded as the most sweeping reform of asset management regulation in the US since the 1940s. As a result, since the enactment of the Dodd-Frank Act and the promulgation of related regulations, asset managers subject to US law have devoted significant time and resources to designing new or revised compliance programmes, hiring new compliance personnel, drafting new disclosures to the government and investors, and amending agreements to meet new requirements.

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II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The key statute in the US applicable to investment advisers is the Investment Advisers Act of 1940 (the Advisers Act). An investment adviser is defined under the Advisers Act to include a person or entity who, for compensation, engages in the business of advising others as to the value of securities or as to the advisability of investing in, purchasing or selling securities.[2] Absent an exemption, an investment adviser must register as such with the Securities and Exchange Commission (SEC).[3]

The most common exemptions from registration as an investment adviser are for advisers solely to venture capital funds, family offices and advisers solely to private funds that have less than US$150 million in assets in the aggregate. Detailed rules have been adopted under each of these exemptions, as well as the exemptions described in the next paragraph, to define applicable terms.[4]

Non-US advisers have two additional exemptions – the private fund adviser exemption and the foreign private adviser exemption. Under the foreign private adviser exemption, an investment adviser is exempt from registration if it:

a has no place of business in the US;

b has fewer than 15 US clients and investors in private funds[5] advised by the adviser;

c has aggregate assets under management attributable to US clients and investors in private funds advised by the adviser of less than US$25 million;

d does not hold itself out generally to the public in the US as an investment adviser; and

e does not act as an adviser to a US registered investment company or a business development company.

Under the private fund adviser exemption, an investment adviser with its principal office and place of business outside of the US is exempt from registration if it has no client that is a US person except for one or more private funds, and all assets under management by the adviser at a place of business in the US are solely attributable to private fund assets, the total value of which is less than US$150 million. To rely on the exemption, the adviser must make certain publicly available periodic informational filings with the SEC.

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2 Certain parties providing investment advice, such as banks, lawyers and broker-dealers, are exempt under certain circumstances from the definition. Although there are other activities that constitute acting as an investment adviser (e.g., publishing reports on securities), this chapter will focus on advisers providing investment advice directly by managing securities portfolios for clients.

3 The SEC is the regulatory agency that implements and enforces the various US federal securities laws.

4 See Advisers Act Rules 202(a)(11)(G)-1, 202(a)(30)-1, 203(l)-1 and 203(m)-1.

5 As described in more detail below in Section III, *infra*, a private fund is a fund relying on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (i.e., funds sold in a private offering to a limited number of investors or exclusively to certain types of sophisticated investors).

Finally, advisers that have registered with the SEC are exempted from state registration requirements. However, such advisers remain subject to state anti-fraud provisions, as well as reporting requirements under certain circumstances. With certain exceptions, advisers with less than US$100 million in assets under management are not permitted to register with the SEC. As a result, these smaller advisers may be subject to state registration requirements if they have clients in a particular state.

An adviser registering with the SEC must file Form ADV, which consists of three parts.[6] Part 1A requests information regarding the adviser and its clients, including assets under management, types of clients, affiliates, disciplinary history and ownership. An adviser to private funds must also provide in Part 1A certain information regarding each private fund that it manages. Part 2A is a brochure containing detailed narrative information regarding the firm's policies, practices, fees, personnel and conflicts of interest. Part 2B is a brochure supplement containing information regarding certain advisory personnel. Parts 1A and 2A are filed with the SEC and are publicly available. Parts 2A and 2B must be delivered to clients upon engagement and periodically thereafter.

Advisers that are registered (or required to register) with the SEC are subject to many substantive requirements of the Advisers Act. The Advisers Act and related SEC rules regulate, *inter alia*, terms of an advisory agreement, performance fees, client solicitation arrangements, political contributions, trading practices, advertising, recordkeeping, proxy voting, personal securities reporting and custody of client assets.[7] A registered adviser must have written compliance policies and procedures reasonably designed to prevent violations of the Advisers Act, which must be administered by a chief compliance officer.[8] The Advisers Act also imposes broad anti-fraud prohibitions, which extend to dealings with clients, prospective clients, and investors and prospective investors in private funds that are advised by the adviser.[9] Additionally, the SEC will periodically examine registered investment advisers for compliance with the Advisers Act, and has the power to bring enforcement actions for non-compliance with the Act, and to impose fines, suspensions and other penalties for violations.[10]

Depending on the type of advisory client and the nature of investments managed by the adviser, other regulatory schemes may apply to the adviser as well. For example, an adviser that uses certain derivative products in client portfolios will need to comply with the Commodity Exchange Act; an adviser that has certain types of retirement plan clients will need to comply with the Employee Retirement Income Security Act of 1974 (ERISA); and an adviser that advises a US-registered investment company will need to comply with the Investment Company Act of 1940 (the Investment Company Act). These and other applicable regulatory schemes are discussed in more detail below.

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6 A fourth part (Part 1B) must be completed by state registrants only.

7 See Advisers Act Section 205, Rule 205-3, Rule 206(4)-3, Rule 206(4)-5, Section 206, Rule 206(4)-1, Rule 204-2, Rule 206(4)-6, Rule 204A-1 and Rule 206(4)-2, respectively, and related SEC guidance.

8 See Advisers Act Rule 206(4)-7.

9 See Advisers Act Section 206 and Rule 206(4)-8.

10 See Advisers Act Section 203.

III COMMON ASSET MANAGEMENT STRUCTURES

i Separately managed accounts (SMAs)

The most common structure for managing assets in the US is an SMA. In an SMA, the client's assets are held by a custodian (typically hired by the client itself), and the adviser enters into an investment management agreement with the client to manage the assets. In this asset management structure, the client and the adviser will negotiate key terms, such as fees and investment objectives, strategies and restrictions. Unlike the funds described below, no corporate form is used to hold the assets, and no securities are issued.

ii Investment companies

Another common structure used to manage assets in the US is an investment company. Investment companies are generally structured as Massachusetts business trusts, Delaware statutory trusts or Maryland corporations,[11] which issue shares to investors in the funds. While investment companies are typically created for retail investors, many funds are intended primarily for institutional investors, or offer separate share classes designed for institutional investors (such as pension funds). Investment companies are generally formed as open-end funds (which issue redeemable securities and typically engage in a continuous offering), closed-end funds (which issue non-redeemable securities, engage in a single offering or periodic offerings and typically list their shares for trading on an exchange) and exchange traded funds (which offer and redeem shares in creation units (share increments of 25,000 or more) and have shares that trade on an exchange).[12]

Investment companies must register as such with the SEC under the Investment Company Act. An investment company registers with the same registration statement used to register its shares for public offering under the Securities Act of 1933 (the Securities Act). A registered investment company is subject to the substantive provisions of the Investment Company Act, which requires, *inter alia*, a board of directors to govern the investment company (at least 40 per cent of which must be independent of the fund's adviser and underwriter) and a written investment management agreement approved by the independent directors prior to execution and annually thereafter. Additionally, the Investment Company Act prohibits, with certain exceptions, transactions with affiliates and the issuance of senior securities (such as incurring debt or issuing preferred shares – which significantly constrains the ability of registered investment companies to employ various forms of portfolio leverage). In addition, certain matters must be approved by shareholders, including, with limited exceptions, new or amended investment management agreements, election of the board of directors and certain changes to investment restrictions.

11 These states have regimes that are advantageous for investment companies (e.g., exempting an investment company from the requirement to hold an annual shareholders' meeting).

12 There are other forms of pooled investment vehicles subject to certain specialised provisions of the Investment Company Act, such as unit investment trusts, face amount certificate companies and business development companies.

If offered to the public, investment company shares must be registered with the SEC under the Securities Act.[13] Registering shares under the Securities Act requires preparing and filing with the SEC a registration statement, which contains disclosure about, *inter alia*, the fund's investment objectives, strategies, investments, advisers, board of directors, investment restrictions, fees and expenses. A prospectus or summary prospectus, which forms a part of the registration statement, must be delivered to shareholders before, or concurrently with, the sale of shares of the investment company. Investment companies that engage in continuous offerings must update their registration statement annually (or sooner if certain material changes occur).

Investment companies must make periodic reports to their shareholders and follow the proxy solicitation rules adopted by the SEC under the Securities Exchange Act of 1934 (the Exchange Act). The Exchange Act and the rules of relevant stock exchanges also impose additional requirements on investment companies with shares that trade on exchanges, such as certain governance requirements.

Because of the difficulties inherent in complying with the Investment Company Act and other US law, non-US investment companies rarely publicly offer their shares in the US.[14]

iii Private funds

Another structure commonly used to manage assets in the US is the private fund. Private funds typically rely on either Section 3(c)(1) (available to a fund with fewer than 100 investors) or Section 3(c)(7) (available to funds with investors that meet certain high wealth thresholds, known as qualified purchasers) of the Investment Company Act to be excluded from the definition of investment company. To qualify under Section 3(c)(1) or 3(c)(7), funds must not make a public offering of their securities.[15] Private funds in the US are typically structured (usually under Delaware law) as limited partnerships or limited liability companies. Such funds may also be established in non-US jurisdictions, such as the Cayman Islands or Bermuda, to achieve tax efficiency for non-US or tax-exempt investors. Private funds may be either open-end (the most common structure for a hedge fund) or closed-end (the most common structure for real estate, private equity and venture capital funds). Most closed-end private funds have a limited life (usually about 10 years) and, rather than requiring an upfront investment, require investors to commit capital that can be called from time to time by the fund.

13 A small percentage of registered investment companies offer their shares only in a private offering, and, therefore, do not register their shares under the Securities Act.

14 For example, non-US investment companies must apply to the SEC for special permission to register as an investment company or publicly offer their shares.

15 If there is no public offering under the Securities Act, the proxy rules and certain other provisions of the Exchange Act do not apply to the private fund (provided that the number of investors remains below certain numerical thresholds). State securities law might still apply, although for most private offerings, only state notice filings (at most) are required.

IV MAIN SOURCES OF INVESTMENT

The United States mutual fund industry is the largest in the world, with a total of US$17.1 trillion in assets at the end of 2013.[16] The largest source of investment into mutual funds are households, which invested an additional US$430 billion in 2013 in long-term registered investment companies.[17]

North America accounts for the largest amount of alternative assets, with Europe ranking second.[18] The private equity market in North America is the largest in the world, raising approximately US$288 billion in aggregate capital in 2013.[19] Public pension funds make up the largest percentage of limited partner commitments in private equity funds (approximately 32 per cent), followed by insurance companies (23 per cent) and corporate pensions (15 per cent).[20] Public pension funds also account for the largest percentage of limited partner commitments in venture capital funds (26 per cent), followed by funds of funds (18 per cent) and corporate pensions (15 per cent).[21]

At year-end 2013, US-based hedge fund managers managed approximately 72 per cent of global hedge fund assets.[22] This percentage is down from 82 per cent at the beginning of the decade.[23] US managers, in over 2,900 firms,[24] manage approximately US$1.92 trillion of the aggregate total hedge fund industry capital.[25] The largest investors in hedge funds include foundations (19 per cent), funds of hedge funds (16 per cent) and private sector pension funds (15 per cent).[26]

V KEY TRENDS

As noted above, in response to the financial crisis, Congress and regulators have adopted and proposed a number of reforms affecting the asset management industry. Seven of the most important changes are summarised below. Additionally, the SEC has recently announced areas of focus for its compliance examinations of registered investment advisers.

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16 Investment Company Institute, *2014 Investment Company Fact Book* (54th ed. 2014).

17 Id at p. 10: '[R]egistered investment companies managed 22 percent of household financial assets at year-end 2013.'

18 Towers Watson, Global Alternatives Survey 2014 14 (July 2014).

19 Preqin Investor Network, *2014 Preqin Global Private Equity Report,* p. 24 (2014).

20 PitchBook Data, Inc. While these numbers are global data, based on our experience, we would expect a similar breakdown for investors in US private equity funds.

21 Id. While these numbers are global data, based on our experience, we would expect a similar breakdown for investors in US venture capital funds.

22 Preqin, *2014 Preqin Global Hedge Fund Report*, p. 25 (2014).

23 TheCityUK, *Hedge Funds 3* (2013).

24 Preqin, Hedge Fund Analyst – Fund Information (Preqin Ltd. 2014).

25 Preqin, 2014 *Preqin Global Hedge Fund Report* p. 27 (2014).

26 Id at p. 57. While these numbers are based on global data, based on our experience, we would expect a similar breakdown for investors in US hedge funds.

i Derivatives

The Dodd-Frank Act includes substantial new requirements with respect to over-the-counter derivative transactions. The changes are largely designed to mitigate systemic risk by decreasing credit risk between parties to derivatives transactions and by increasing transparency in derivatives markets. Certain of the new requirements have become effective, but many other requirements have not yet been implemented, so the ultimate impact of these provisions remains unclear.

Some of the key requirements are as follows:

Clearing

Certain interest rate swaps and credit default index swaps are required to be cleared through a central clearing house, and it is expected that some other types of derivatives transactions will become subject to this requirement in the future.

Margin

Central clearing houses impose initial and margin requirements on cleared derivatives transactions, which can change at any time and which are often higher than existing margin requirements for uncleared derivatives transactions. In addition, various regulators (including the Commodity Futures Trading Commission (CFTC),[27] the SEC and US bank regulators) are expected to adopt rules in the future that will require minimum amounts of initial and variation margin for uncleared derivatives transactions, which are expected to be higher than the requirements for cleared transactions. It is uncertain what effect these higher margin requirements will have on the liquidity of the derivatives markets.

Trading

Certain benchmark interest rate swaps and frequently traded credit default index swaps are required to be executed on a swap execution facility or exchange, rather than on a bilateral basis. It is expected that some other types of derivatives transactions will become subject to this requirement in the future. There is an exception from this requirement for block trades, which are trades sufficiently large to exceed thresholds established by the CFTC from time to time.

Reporting

All over-the-counter derivatives transactions are required to be reported to a swap data repository. The swap data repository makes the reported data available to various regulators, and makes certain of the reported data (not including the identity of the parties) available to the public. If one of the parties to a derivatives transaction is registered as a swap dealer and the other party is not, the swap dealer is the only party with the reporting obligation (regardless of whether the swap dealer is organised in the US).

27 The CFTC is the regulator that administers and enforces the Commodity Exchange Act.

Documentation and business conduct standards

Swap dealers are required to have swap trading relationship documentation (such as an International Swaps and Derivatives Association (ISDA) master agreement) in place with their derivatives counterparties before a derivatives transaction is executed, and are subject to rules regarding timely confirmation of trades and a requirement to conduct periodic portfolio reconciliation with their counterparties. Swap dealers also have generally been seeking substantial additional representations from their counterparties to comply with (and meet certain safe harbours under) business conduct standards. Many market participants have amended their derivatives documentation to comply with these requirements by adhering to market protocols prepared by ISDA.

ii Money-market fund reform[28]

In response to well-publicised 'races to the exit' which occurred in 2008 as money-market fund investors sought to avoid sharing in losses such funds sustained in Lehman Brothers securities, in July 2014 the SEC adopted rules designed to reduce possible systematic risks that regulators believe money-market funds may present. Currently, money-market funds generally value their portfolio holdings using the amortised cost method, which results in a stable net asset value of US$1 per share (for purposes of shareholder purchases and redemptions) even in circumstances where the underlying portfolio holdings may be worth fractionally more or less than US$1.

Under the new rules, certain money-market funds will be prohibited, beginning in 2016, from using amortised cost to value their investments and consequently will have a floating net asset value per share. The new rules also require certain liquidity fees on redemptions and give the fund's board of directors authority to suspend redemptions under certain circumstances. More stringent requirements relating to diversification, disclosure, stress testing and reporting are also imposed.

iii The Jumpstart Our Business Startups Act (the JOBS Act)

In 2012, Congress adopted the JOBS Act, which required, *inter alia*, that the SEC amend Regulation D (an exemption from registration under the Securities Act) to remove the prohibition on general solicitation or general advertising of certain offerings of securities to accredited investors (investors who satisfy certain financial thresholds). In 2013, the SEC amended Regulation D, and private funds may now use general solicitation or general advertising to offer and sell fund interests so long as the fund takes reasonable steps to verify that the purchasers are in fact accredited investors. It is unclear to what extent private funds will rely on the new rules, as verification procedures would need to be developed and general solicitations in the US might affect the fund's ability to rely on private placement exemptions in non-US jurisdictions. Additionally, commodity pool operators relying on Rule 4.13(a)(3) (see below) cannot currently engage in a public

28 US-registered money-market funds held approximately US$2.72 trillion in assets at year-end 2013. See Investment Company Institute, *2014 Investment Company Fact Book* p. 196 (54th ed. 2014).

offering, and it is unclear whether general solicitation with respect to a commodity pool would preclude such reliance.

iv Bad actor rules

As required by the Dodd-Frank Act, in 2013 the SEC adopted amendments to disqualify funds and other market participants from relying on Regulation D if 'bad actors' participate in the fund's Regulation D offering. Disqualification may result if any of the following is a bad actor: the fund's investment adviser and certain personnel at the adviser, the fund and certain personnel at the fund, and the fund's promoters, placement agents and certain personnel at a placement agent. 'Bad actors' are persons who have committed violations of certain anti-fraud provisions of state or federal securities laws and other similar regulations or certain criminal offences.

v Registration under the Commodity Exchange Act

Under the Commodity Exchange Act, the operator of a commodity pool (i.e., a fund that invests in at least one commodity contract) must register as a commodity pool operator (CPO),[29] and an adviser providing advice with respect to commodity contracts must register as a commodity trading advisor (CTA) (in each case, absent an exemption from registration). Before the Dodd-Frank Act, commodity contracts subject to the Commodity Exchange Act included futures, options on futures, options on commodities and certain foreign exchange contracts. The Dodd-Frank Act amended the definition of commodity contract to encompass a much broader range of derivatives contracts, including interest rate derivatives, derivatives over a broad-based securities or credit index, other commodity derivatives, and currency derivatives (other than deliverable currency forwards).

In addition, although not required by the Dodd-Frank Act, the CFTC amended its rules to eliminate a common exemption from CPO registration (which permitted a fund to use commodity contracts without limit so long as certain investor sophistication and other requirements were met).[30] As a result, the only remaining potential CPO registration exemption for most CPOs is Rule 4.13(a)(3), which provides an exemption only if all investors meet certain moderately low wealth standards, there is no public offering of fund interests and either:

a no more than 5 per cent of the fund's assets are used as initial margin or premiums for commodities contracts; or

b the net notional value of the fund's commodity contracts is less than 100 per cent of the fund's net asset value.

29 The CPO is typically the general partner of a private fund or the adviser of an investment company.

30 There are various CTA registration exemptions as well, although these have not been materially changed recently (with the exception of various CTA exemption tests amended to reflect the broader definition of commodity contracts).

Finally, it is worth noting that the CFTC takes the position that the operator of a fund (including a fund organised and operated outside the US) with one or more US investors, or that enters into any uncleared derivatives with a US counterparty, is subject to CPO registration (or must find an exemption).

A registered CPO or CTA is subject to various reporting, disclosure and record-keeping requirements (which vary depending on the sophistication of the client or investors in the fund). Additionally, a registered CPO or CTA must become a member of the National Futures Association, a self-regulatory organisation, and is subject to examination by the National Futures Association or the CFTC.

vi Volcker Rule

The Dodd-Frank Act amended the Bank Holding Company Act by adding a new Section 13, commonly known as the Volcker Rule, that curbs certain investment activities by banks and their affiliates. The Volcker Rule prohibits banking entities – broadly defined to include banks, parents of banks and subsidiaries and affiliates of either of them – from engaging in proprietary trading in securities, derivatives, or certain other financial instruments, and from investing in, sponsoring, or having certain relationships with a hedge fund or private equity fund, subject to a number of exceptions.

After a three-and-a-half-year process, final regulations to implement the Volcker Rule were adopted in December 2013. Those subject to the new law are engaged in planning and preparedness activities that will enable them to conform their activities and investments to the requirements of the law and regulations no later than 21 July 2015. The final regulations eliminated much of the ambiguity that existed during the proposal phase of the regulatory process, but significant interpretative issues remain.

vii Municipal advisors

On 20 September 2013, the SEC adopted rules[31] to establish a permanent registration regime for municipal advisors. These rules implement provisions of the Dodd-Frank Act, which generally prohibit municipal advisors from soliciting or providing certain advice to municipal entities without first registering with the SEC. Municipal advisors include persons who provide advice to or on behalf of a municipal entity with respect to municipal financial products or the issuance of municipal securities; or undertake a solicitation of a municipal entity. 'Municipal entities' are US states, their political subdivisions and certain related entities. In general, SEC-registered investment advisers are excluded from the definition of municipal advisor to the extent that a registered investment adviser 'is providing investment advice in such capacity.' Unregistered investment advisers may be considered municipal advisors if a municipal entity has invested the proceeds of an issuance of municipal securities in a fund or SMA managed by such adviser. Unregistered investment advisers to separately managed accounts for municipal entities may also be considered municipal advisors if the account holds any swaps or securities-based swaps. Unregistered investment advisers have a due diligence requirement to determine whether a fund or account holds the proceeds of a municipal securities issuance.

31 See Exchange Act Rules 15Ba1-1–15Ba1-8.

viii SEC examination priorities

In January 2014 the SEC published its 2014 examination priorities, which reflect topics that the SEC staff perceives to have heightened risk and to which the SEC's National Examination Program expects to allocate significant resources throughout 2014. These topics include, with respect to investment advisers and investment companies:

a information technology systems, information security and the ability of advisers to respond to sudden malfunctions and system outages;

b compliance with the custody rule under the Advisers Act and confirming the existence of assets through a risk-based asset verification process;

c conflict of interest risks in compensation arrangements, allocation of investment opportunities, side-by-side management of performance-based and purely asset-based fee accounts, illiquid investments, leveraged investment strategies, and higher risk strategies targeted to all retail investors;

d general solicitation practices and verification of accredited investor status under the JOBS Act; and

e funds offering alternative investment strategies—focusing on valuation, liquidity and leverage policies and practices; board oversight, compliance personnel and back offices; and marketing.

VII SECTORAL REGULATION

i Insurance

Insurance companies are regulated primarily by the states and therefore each state will have different laws regarding the management of insurance company assets. Although there is no comprehensive federal insurance regulatory scheme, many of the federal laws described above affect insurance company investments.

Assets of insurance companies are typically managed in general accounts or separate accounts. When an insurance company issues variable annuity or life insurance policies, the insurance company will segregate in a separate account assets to satisfy its obligations under the policies. Typically, separate accounts are organised as unit investment trusts (UITs), which in turn invest in an open-ended investment company that invests directly in securities. Separate accounts may also be organised as open-ended investment companies that invest directly in a portfolio of securities. Separate accounts holding assets from publicly offered variable annuity or variable life insurance products are considered investment companies under the Investment Company Act and are subject to applicable Investment Company Act, Securities Act and related regulations.

Insurance company general account assets are managed on behalf of the insurance company (rather than for the benefit of a specified group of policyholders). If general account assets are managed by the insurance company itself, the general account is not considered a client of the insurance company for Advisers Act purposes (as the investment advice is not being provided to others).

ii Pensions

The requirements of ERISA apply to the manager of a pooled investment vehicle or SMA that is treated as holding plan assets. If a benefit plan investor invests in a pooled

investment vehicle or SMA, then, unless an exemption applies, the underlying assets of the fund are deemed to be plan assets for purposes of ERISA. Benefit plan investors include most US private sector retirement plans (such as pension and 401(k) plans), Taft-Hartley (multi-employer) union pension plans and individual retirement accounts. Exemptions exist for funds that issue publicly offered securities, registered investment companies, venture capital operating companies and real estate operating companies (which exempts many private equity, venture capital and real estate funds), and funds with less than 25 per cent of each class of equity interest in the fund held by benefit plan investors.

If a fund or account holds plan assets, then (absent an exemption) the manager must satisfy ERISA's fiduciary standards. Under these standards, the manager must act solely in the interest of the investing plan's participants, act prudently with respect to decisions affecting the plan, diversify the plan assets under its management (subject to the investment guidelines issued to it by the plan's trustee), and act in accordance with the documents and instruments governing the plan. Additionally, the manager cannot receive more than reasonable compensation; must not engage in, or cause the client to engage in, non-exempt prohibited transactions (i.e., transactions with parties related to the plan, including other service providers for the plan, and self-dealing); and must be bonded under a fidelity bond. Finally, the manager must assist the investing plans in satisfying their reporting obligations, including disclosing its compensation for the services provided.

If an adviser is a qualified professional asset manager (QPAM), certain of the rules regarding prohibited transactions are relaxed.[32] For example, if the conditions for using the QPAM exemption are met, the prohibition on transactions with parties related to the plan applies only to those parties that have the ability to appoint or terminate the manager, parties that (together with their affiliates) account for more than 20 per cent of the manager's total client assets under management, and parties in interest that are a person related to the QPAM under complex common ownership rules. To qualify as a QPAM, the adviser, if not a bank or insurance company, must be registered under the Advisers Act, and generally must have more than US$85 million in assets under management and more than US$1 million in shareholder or partner equity.

Certain transactions are limited or prohibited for ERISA clients under the self-dealing rules, even if the adviser is a QPAM. These include certain incentive compensation arrangements, cross trading and use of an affiliated broker-dealer. However, conditional exemptions from these prohibitions are relied upon by many advisers.

If a fiduciary breaches its duties under ERISA, the fiduciary will be required to restore any losses to the plans resulting from the breach, and may be subject to certain penalties and taxes.

iii Real property

As the Advisers Act definition of investment advisers relates only to advice with respect to securities, advisers dealing in real estate are only required to register under the Advisers

32 This exemption is relied upon by most large managers of plan assets.

Act if they provide advice relating to securities in addition to real estate. However, as such advisers may advise on real estate-related securities (e.g., mezzanine loans, mortgage-backed securities or limited partner interests in partnerships that own real estate), many real estate advisers have registered as investment advisers.

Real estate advisers commonly provide investment advice to clients through SMAs (which may co-invest with the adviser or other clients, or with both, in real estate joint ventures), single asset or programme joint ventures, real estate investment trusts (REITs) and private funds.

Real estate private funds that may invest in securities often rely on Section 3(c)(5)(C) under the Investment Company Act for exclusion from the definition of investment company (available to funds primarily engaged in the business of purchasing or otherwise acquiring mortgages and other liens on and interests in real estate)[33] and on Regulation D under the Securities Act.

REITs allow investors to make passive investments in real estate on a tax-advantaged basis. Qualification as a REIT is complex and requires ongoing compliance with organisational, asset and income tests under the Internal Revenue Code. Requirements for a REIT to qualify for pass-through taxation include that a REIT must invest at least 75 per cent of its assets in real estate or qualifying assets; at least 90 per cent of a REIT's annual taxable profits must be distributed to shareholders as dividends; and a REIT must have at least 100 shareholders and cannot be closely held. REITs may be privately or publicly offered. Privately offered REITs are typically offered pursuant to Regulation D under the Securities Act. Publicly offered REITs are subject to the Securities Act and Exchange Act, including the reporting requirements for public companies. REITs that may invest in securities typically rely on Section 3(c)(5)(C) for an Investment Company Act exemption.

iv Hedge funds

A number of the key trends discussed above (e.g., derivatives regulation, Commodity Exchange Act registration, the JOBS Act and bad actor rules) directly affect hedge funds and their advisers. Also as noted, the Volcker Rule requires banking entities to limit substantially certain relationships they may have had with hedge funds.

Additionally, the SEC has also recently adopted Form PF, which requires detailed information about each hedge fund managed by a registered investment adviser. The form is filed periodically with the SEC on a confidential basis (either annually or quarterly, depending on assets under management), and advisers must include extensive information regarding a fund's strategy, investors, derivatives, leverage, investments, counterparties, turnover, exposures, risk metrics, financing and investor liquidity.

v Private equity

As with hedge funds, the JOBS Act, bad actor rules and Volcker Rule will affect the operations of private equity funds and their advisers. Applying the Advisers Act, which is

33 Institutional real estate private funds typically also qualify under Section 3(c)(7) of the Investment Company Act for exclusion from the definition of investment company.

primarily designed for advisers managing publicly traded securities for retail investors, to private equity firms has proven to be complicated. As a result, private equity firms have been put in the position of internally resolving numerous interpretive issues without clear guidance from regulators.

In their examinations of, and public statements regarding, private equity firms, the SEC staff has focused on the valuation of private equity investments, allocation of fees and expenses between the adviser and the funds and the adviser and portfolio companies, and the allocation of co-investment opportunities. Additionally, the SEC staff has raised questions as to whether broker–dealer registration should be required in respect of certain common practices of private equity firms, including the marketing of private equity fund interests and the receipt by private equity firms of transaction-based compensation in connection with capital markets or merger and acquisition activity relating to portfolio companies.

Advisers to private equity funds must also file Form PF annually. Depending on the assets under management of the private equity firm, these filings must include information regarding each fund's leverage, derivatives holdings, investors and portfolio companies.

VIII TAX LAW

i Separately managed accounts

For US clients, net investment income generated by investments is taxed as ordinary income. Taxes on capital gains from the sale of securities will be determined by how long the client owned the investments that generated them. To the extent that US clients are taxed by non-US jurisdictions due to investments in non-US issuers (such as a foreign withholding tax), US tax credits may be available to such clients.

Non-US clients will be subject to withholding at a rate of 30 per cent on dividends from US sources, although the withholding may be reduced depending on the status of the investor (e.g., foreign governments are exempt) or the tax treaty between the US and the country of the non-US client. Interest income from US sources is generally exempt from US withholding for non-US non-bank investors that meet certain requirements (such as submitting a Form W-8BEN). Non-US clients will not typically need to file a US tax return due to investments in the US, except in limited circumstances, such as investments in United States real property interests (i.e., interests in real property, as well as the stock of any corporation that holds sufficient interests in US real property to be considered a United States real property holding company).

ii Registered investment companies

An investment company that qualifies as a regulated investment company under Subchapter M of the Internal Revenue Code generally will not be subject to US federal income tax on its income and capital gains that it timely distributes to shareholders. To so qualify, the investment company generally must, *inter alia*:

a derive at least 90 per cent of its gross income for each taxable year from certain proceeds derived with respect to its business of investing in stock, securities or currencies;

b meet certain portfolio diversification tests; and

c distribute with respect to each taxable year at least 90 per cent of the sum of its investment company taxable income (which term includes short-term gains) and any net tax-exempt interest income, for such year.

If an investment company were to fail to meet the income, diversification or distribution tests described above, and were ineligible to, or did not, cure such deficiencies in the manner presented in the Internal Revenue Code, the investment company would be subject to tax on its taxable income and gains at corporate rates, and all distributions from earnings and profits would be taxable to shareholders as ordinary income.

Dividends received from an investment company, as well as any gains from the sale of fund shares, are generally subject to tax in the hands of shareholders subject to US federal income tax.[34]

Distributions of long-term capital gains (capital gain dividends) are generally not subject to US federal income tax withholding for non-US shareholders. Under current law, dividends other than capital gains dividends (including distributions of short-term capital gains) paid by a fund to a non-US shareholder generally are subject to withholding of US federal income tax at a rate of 30 per cent, or a lower applicable tax treaty rate, even if they are funded by income or gains that, if paid to a foreign person directly, would not be subject to withholding. However, a statutory exemption from withholding applied to certain of such dividends paid with respect to taxable years beginning before 1 January 2014; it is currently unclear whether this statutory exemption will be extended for taxable years beginning on or after 1 January 2014.

iii Private funds

Private funds in the US typically elect to be treated as a partnership for US federal income tax purposes.[35] If the fund were not treated as a partnership, but as an association taxable as a corporation:

a fund income or gains will be taxed, and losses trapped, at the fund level rather than being passed through to the partners of the fund;

b distributions to investors in the fund would be treated as dividends; and

c additional adverse tax, reporting and filing consequences could be triggered.

As a partnership for tax purposes, the fund itself does not pay US federal income tax. Income, gains, losses, deductions and credits of the fund will be allocated to the investors for US federal income tax purposes in accordance with the applicable governing documents.

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34 Very generally, distributions of investment income and net short-term capital gains are taxed at ordinary income rates. Distributions of net long-term capital gains and, so long as the fund and the US shareholder meet certain requirements, dividends constituting 'qualified dividend income' are taxed at the lower rates applicable to long-term capital gains.

35 In some cases, tax-exempt investors invest through a corporation to prevent certain disadvantageous tax attributes from applying to investments.

In general, the US federal tax treatment of a non-US investor will depend on whether the fund is deemed to be engaged in a US trade or business. US-source income not effectively connected with a US trade or business may be subject to US withholding tax. If the fund were determined to be engaged in a US trade or business, either generally, or because the fund invests in turn in a pass-through entity (such as a partnership) so engaged, the income effectively connected with such trade or business would be subject to: (1) US federal income taxation, including in the case of such a vehicle treated as a partnership; and (2) withholding on each non-US investor's distributive share of such income. Further, each non-US investor would be required to file a US federal income tax return reporting such income (and potentially all its other US-sourced income for the taxable year). In addition, any income from the disposition of a United States real property interest held directly or indirectly by the fund would be treated as income effectively connected with a US trade or business. Accordingly, such income would be subject to US taxation and withholding, and each non-US investor would be required to file a US federal income tax return reporting its distributive share of such income.

iv Foreign Account Tax Compliance Act of 2009 (FATCA)

FATCA establishes a new information reporting regime to identify US persons holding assets through offshore entities and overseas accounts. Non-compliance with FATCA generally leads to a 30 per cent withholding tax on most US source income and, potentially, on all or a portion of non-US source income. The FATCA regime institutes significant changes not only for offshore entities (such as non-US funds and banks) but also for US entities (such as US private investments funds, regulated investment companies and US banks) that are required to implement the new FATCA reporting and withholding procedures. The FATCA withholding tax began to be phased in on 1 July 2014.

VIII OUTLOOK

The effects of the changes in regulation described above are not yet completely known. As a result, there are still many questions that will be answered in time, including:

a how the derivatives markets will adjust to new regulation;
b how banks will respond to the new regulations;
c how money-market fund regulation will affect their operation; and
d whether and how private funds will take advantage of general solicitation and advertising.

Finally, and perhaps most importantly, it remains to be seen whether the new regulations will, in fact, improve the functioning of the markets, better protect investors and help prevent another financial meltdown, or whether they will only increase transaction and compliance costs and create barriers to entry into the asset management business.

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Jason Brown has extensive experience representing investment advisers to private equity funds, venture capital funds, hedge funds, mutual funds, separate accounts and commodity pools. He has assisted over 35 leading private equity firms in registering as investment advisers with the SEC and developing Advisers Act compliance programmes, and has assisted numerous non-US private equity firms in analysing their regulatory obligations under US law. In addition, he has advised a wide variety of US and non-US investment advisers on Advisers Act, Investment Company Act and Commodity Exchange Act matters as new funds or products are launched, compliance questions arise, new rules are adopted, or SEC or NFA inspections occur. He also focuses on the representation of other investment management clients, including open and closed-end mutual funds and their directors.

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