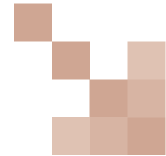
United States



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RETAIL FUNDS

1. Please give a brief overview of the retail funds market in your jurisdiction. (How developed is the market? Has it been active in the past year?)

Open-ended retail funds

The open-ended retail or mutual fund market in the US is very active and is the principal financial product for US retail investors in both taxable and retirement accounts, with over US$9.2 trillion (about EUR6.6 trillion) in assets invested in over 8,000 funds offered by over 680 fund sponsors.

The total number of open-ended funds grew modestly from 2000 to 2006, but now is back to the 2000 level, with a small annual turnover of new funds replacing those that have been merged or liquidated. In recent years, there has been a decrease in the total number of open-ended fund sponsors, particularly among independent investment advisers. However, independent investments advisers continue to comprise a majority of fund sponsors, with banks, insurance companies, brokers and non-US advisers collectively accounting for sponsorship of approximately 40% of total open-ended funds. In 2008, mutual funds were affected by the financial disruption in the markets, although generally to a lesser extent than hedge funds due to the more restrictive regulatory requirements on leverage and use of derivatives. Several money market funds "broke the buck" failing to maintain a net asset value of US$1 per share and were forced to liquidate.

Closed-ended retail funds

The closed-ended mutual fund market in the US is smaller in scope to the open-ended market, with approximately 650 funds and 721 exchange traded funds (ETFs), with assets of US$238 billion (about EUR170 billion) and US$478 billion (about EUR340 billion), respectively. The ETF market, which focuses on baskets of securities generally representing market or industry indexes, has expanded significantly in recent years as investors and financial advisers have sought lower cost portfolio management tools to achieve market performance.

During 2008, many closed-ended funds had difficulties associated with refinancing their auction rate preferred stock, a widely used leverage financing mechanism, as auction rate dealers (facing their own financial difficulties) ceased providing backstop bids in periodic auctions.

2. What are the key statutes, regulations and rules that govern retail funds in your jurisdiction? What regulatory bodies are involved in regulating retail funds?

Open-ended retail funds

Open-ended mutual funds are extensively regulated in the US through the following federal and state regulatory regimes:

- **Investment Company Act of 1940 (Investment Company Act).** This is a federal securities law administered by the Securities and Exchange Commission (SEC) regulating the registration and operation of investment companies.
- **Securities Act of 1933 (Securities Act).** This is a federal securities law administered by the SEC regulating the registration of public securities offerings in the US and the disclosure content of offering materials sent to investors.
- **Investment Advisers Act of 1940 (Advisers Act).** This is a federal securities law administered by the SEC regulating investment advisers (for example, fund sponsors).
- **State blue sky laws.** These are the securities laws of each state (and usually administered by a state securities agency) regulating the public offering of securities to state residents. Open-ended mutual funds are usually required to make notice filings and pay registration fees in such states.
- **Securities Exchange Act of 1934 (Exchange Act) and Financial Industry Regulatory Authority (FINRA) regulation.** Federal securities law administered by the SEC and its broker-dealer self-regulatory body for brokers (FINRA) regulate the sales of mutual fund shares and certain aspects of exchange traded closed-ended funds.
- **Specialised regulatory regimes.** These include regimes such as the Commodity Exchange Act of 1974 (Commodity Exchange Act), for funds' use of financial futures, and anti-money laundering and financial privacy regulation.

Closed-ended retail funds

Closed-ended retail funds are subject to the same regulatory regimes as open-ended funds (*see above, Open-ended retail funds*). In addition, closed-ended funds may be subject to certain stock exchange listing rules for any stock market on which the closed-ended fund's shares trade.

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3. Do the retail funds themselves have to be authorised or licensed? If so, what are the main steps involved?

Open-ended retail funds

Any open-ended fund that wants to offer its shares to the public in the US must both register the fund under the Investment Company Act and register its offering under the Securities Act. Registration under the Investment Company Act and Securities Act are each accomplished by filing a combined registration statement on Form N-1A with the SEC, which is then reviewed and typically would require one or more amendments to reply to SEC comments. Filings must also be made in each state in which retail sales will be made.

Closed-ended retail funds

Closed-ended retail mutual funds that want to offer and sell shares to the public in the US must also register under the Investment Company Act and register any securities offerings under the Securities Act (on Form N-2). Closed-ended funds listing shares on an exchange must go through the stock exchange listing process for the particular exchange.

4. Who can market retail funds?

Open-ended retail funds

Open-ended mutual funds may be marketed and sold by SEC/FINRA registered broker-dealers or directly by the fund without SEC/FINRA registration. Generally, broker-dealers must also be licensed in states in which they market funds. Many US open-ended funds have extensive distribution relationships with numerous broker-dealer firms or other financial intermediaries.

Closed-ended retail funds

Closed-ended retail mutual funds are sold through underwritten syndicated public offering transactions, with one or more registered broker-dealer managing underwriters and often sold through those broker-dealers' sales force.

5. To whom can retail funds be marketed?

Open-ended retail funds

There are no general US regulatory restrictions on the type of investor that can invest in open-ended mutual funds. Broker-dealers engaged in the sale of mutual funds must ensure that the security recommended is generally suitable for a particular buyer based on the investor's risk tolerance and financial circumstances.

Closed-ended retail funds

A similar situation applies as for open-ended retail funds (*see above, Open-ended retail funds*).

6. What are the key requirements that apply to managers/operators of retail funds?

Open-ended retail funds

Investment advisers to open-ended mutual funds:

- Must be registered with the SEC as an investment adviser under the Advisers Act.
- Must not be subject to certain disqualifying regulatory or criminal events.
- Are subject to regulation in relation to dealings with the fund.

The investment advisory agreement with a mutual fund must be approved by the independent directors of the fund and the fund's shareholders. In addition, the contract must be approved annually by the independent directors (after an initial term of two years) and terminates automatically if assigned by the investment adviser, including through a direct or indirect change of control of the adviser.

The compensation payable to the investment adviser is scrutinised by the fund's independent directors to ensure it is reasonable using comparisons to industry comparables and other factors. This compensation is usually based on a percentage of fund net assets and may not be performance based with limited exceptions for fulcrum fees (a fee that increases or decreases proportionately based on the performance of the fund compared to a benchmark).

Investment advisers are subject to high fiduciary standards in their dealings with open-ended funds, including:

- Disclosure of material information relating to their services and conflicts of interest.
- Restrictions on transactions involving the fund.

Investment advisers are required to maintain formalised compliance policies and procedures and are subject to SEC inspection and oversight. Investment adviser personnel are subject to extensive personal securities transaction regulation and adviser oversight and reporting.

Closed-ended retail funds

A similar situation applies as for open-ended retail funds (*see above, Open-ended retail funds*).

7. Who holds the portfolio of assets? What regulations are in place for its protection?

Open-ended retail funds

Mutual funds registered under the Investment Company Act must have their securities and cash held by a qualified custodian (usually a bank or broker-dealer).

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Closed-ended retail funds

The same rules apply as for open-ended retail funds (*see above, Open-ended retail funds*).

8. What are the main legal vehicles used to set up a retail fund and what are the key advantages and disadvantages of using these structures? What are the participants' interests in the fund called (for example, share or unit)?

Open-ended retail funds

Mutual funds are usually established as either a:

- Business trust (for example, a Massachusetts business trust or Delaware business trust).
- Corporation in a state with favourable corporate laws for funds, such as Maryland.

The security issued by the fund might be common stock, shares or units depending on the form of entity. Registered funds in the US must be domestic entities and may not be a non-US entity without special SEC relief, which is not typically granted (*Investment Company Act*). The jurisdiction of incorporation varies depending on local state taxation concerns and the flexibility of the authorising law versus the desire for certainty of a robust corporate statute. Certain business trusts may require longer organisational documents but may provide greater flexibility to make changes and avoid shareholder votes on items such as liquidations, name changes or other matters.

Closed-ended retail funds

The same situation generally applies as for open-ended retail funds (*see above, Open-ended retail funds*). In addition to common equity, closed-ended funds may also issue preferred stock.

9. Describe the investment and borrowing restrictions to which retail funds are subject.

Open-ended retail funds

Under the Investment Company Act, open-ended mutual funds are subject to the following types of investment restrictions:

- Open-ended funds must describe in their investor disclosure documents, and cannot change without shareholder approval, policies concerning:
  - diversification of the fund's investments;
  - borrowing money;
  - issuing senior securities;
  - underwriting securities;
  - purchasing or selling real estate;
  - purchasing or selling commodities;
  - making loans to other persons;
  - industry concentration;
  - investing in other investment companies.
- Certain of these activities are also subject to restrictions under the Investment Company Act.
- Open-ended funds are subject to the following additional restrictions on investments:
  - restrictions on illiquid securities;
  - for money market funds, quality, diversification and maturity standards;
  - for funds using a name implying certain securities will be held, at least 80% of the fund's assets must be consistent with the fund's name.
- Borrowings or investments that involve leverage are generally restricted under the Investment Company Act to one-third of a fund's total assets (including the amount borrowed).

Closed-ended retail funds

Generally the same as for open-ended funds (*see above, Open-ended retail funds*), except closed-ended funds may issue preferred stock and the one-third of total assets borrowing ratio described above is relaxed to a borrowing ratio of up to one-half of total assets.

10. Can the manager/operator place any restrictions on the issue and redemption of interests in retail funds?

Open-ended retail funds

Restrictions on the issue of shares may apply through the distribution process, such as selling only through certain channels, imposing minimum investment sizes or opening or closing new subscriptions to the fund. Open-ended retail funds must allow investors to redeem shares and be paid within seven days. Redemption proceeds must generally be paid in cash, except an open-ended fund can make an election to allow redemptions in kind, subject to the requirement to pay some of the redemption in cash. Open-ended funds can apply a sales charge on sales and a redemption fee of up to 2% of the redemption amount.

Closed-ended retail funds

Generally, there are no restrictions on issuances. Closed-ended funds usually bear a sales charge. Closed-ended retail funds in the US typically rely on stock exchange listings and an active trading market to provide investor liquidity.

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11. Describe any restrictions on the rights of participants in retail funds to transfer or assign their interests to third parties.

Open-ended retail funds

Transfers of interests would generally not be restricted but most retail investors would usually rely on redemption features to achieve liquidity.

Closed-ended retail funds

Transfers of interests would generally not be restricted but most retail investors would usually rely on a stock market sale to achieve liquidity.

12. Describe the periodic reporting requirements to:

- **Investors.**
- **Regulators.**

Open-ended retail funds

- **Investors.** Open-ended funds must provide the following to investors:
  - a prospectus, including financial and investment performance information, on purchase and annually thereafter;
  - on request, a more lengthy statement of additional information;
  - audited annual and unaudited semi-annual reports, including financial and investment performance information;
  - information regarding tax distributions made by the fund.
- **Regulators.** In addition to providing information to investors, open-ended retail funds must also file with the SEC:
  - the fund's proxy voting record;
  - a copy of the fund's fidelity bond (a bond which indemnifies for loss caused by a dishonest or fraudulent act by an employee), as required under the Investment Company Act;
  - a notice of securities sold and redeemed on which a fee has been paid to the SEC;
  - a semi-annual report on Form NSAR containing certain financial information and disclosing whether certain transactions have occurred;
  - a Sarbanes-Oxley Act certification of fund financial statements.

Closed-ended retail funds

- **Investors.** Generally the same as for open-ended funds (*see above, Open-ended retail funds: Investors*), except the fund's prospectus and statement of additional information usually would not be updated annually.
- **Regulators.** Generally the same as for open-ended funds (*see above, Open-ended retail funds: Regulators*), except for any special filings required by any stock exchange on which the fund's shares are listed.

13. Describe the tax treatment for:

- **Funds.**
- **Resident investors.**
- **Non-resident investors.**

Open-ended retail funds

- **Funds.** Open-ended funds rely on Subchapter M of the Internal Revenue Code of 1986 to avoid corporate level tax on the fund. To receive Subchapter M treatment, the fund must:
  - derive at least 90% of its gross income from dividends, interest, gains from the sale of securities or other investment related income;
  - distribute to its investors annually at least 90% of both:
    - its ordinary income (for example, interest and dividend income);
    - the excess of its realised short-term capital gain over its net realised long-term capital loss.
  - maintain a minimally diversified portfolio as of each quarter ended.
- **Resident investors.** For federal income tax purposes, all dividend paid by an open-ended fund and distributions of net realised short-term capital gains are taxable to the investor as ordinary income whether reinvested or received in cash unless the investor is exempt from taxation or entitled to a tax deferral. To the extent the fund has received qualifying dividend and designates a portion of its distribution as such, investors may be entitled to treat the ordinary income as qualifying dividend eligible for the long-term capital gains tax rate or, in the case of a corporate investor, as eligible for the dividend received deduction. Distributions paid by a fund from net realised long-term capital gains, whether received in cash or reinvested in additional shares, are taxable as a capital gain. The capital gain holding period is determined by the length of time the fund has held the security and not the length of time the investor held shares in the fund. Capital gains and dividend may also be subject

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to state or local taxes. If an investor is not required to pay taxes on income, the investor is generally not required to pay federal income taxes on the amounts distributed by a fund. Redemptions or other sales of fund shares, including exchanges, may result in a capital gain or loss for federal tax purposes. A capital gain or loss on an investment in a fund generally is the difference between the cost of shares and the price received when sold.

- **Non-resident investors.** Unless a non-resident's receipt of a fund dividend is effectively connected with the entity's conduct of a US trade or business, the non-resident is subject to withholding tax at 30% (or lower treaty rate) on dividend received from the fund, whether or not reinvested. (A non-resident receiving income from or with respect to a fund that is effectively connected to such non-resident's conduct of a US trade or business is not subject to withholding, but must pay federal income tax on a net income basis, similar to a resident investor.) Withholding generally does not apply to long-term capital gain dividend or, for years of the fund beginning before 31 December 2009, to distributions designated and properly qualified as interest-related dividend or short-term capital gains dividend.

Closed-ended retail funds

- **Funds.** The tax treatment is the same as for open-ended retail funds (*see above, Open-ended retail funds: Funds*).
- **Resident investors.** The tax treatment is the same as for open-ended retail funds (*see above, Open-ended retail funds: Retail investors*).
- **Non-resident investors.** The tax treatment is the same as for open-ended retail funds (*see above, Open-ended retail funds: Non-resident investors*).

14. Please summarise any proposals for the reform of retail fund regulation in your jurisdiction.

Retail fund regulation is subject to ongoing regulatory changes. Current material initiatives of the SEC for retail fund regulation include:

- Review of 12b-1 asset based distribution charges for funds allowing the use of fund assets to pay for distribution and marketing.
- Review of soft dollar practices of using fund assets to pay for research and brokerage costs through potentially higher commissions on securities transactions.
- Whether to require fund boards to have an independent chairman for the board of directors.
- Proposed changes to the content of prospectuses and a short form summary prospectus that could be used for sales.

HEDGE FUNDS

15. Please give a brief overview of the hedge funds market in your jurisdiction. (How developed is the market? Has it been active in the past year?)

The US is one of the most developed and active markets for hedge funds in the world. Although difficult to measure with precision, assets managed by hedge funds in the US are estimated to be between approximately US$0.75 trillion (about EUR0.53 trillion) and US$1.5 trillion (about EUR1.06 trillion), or 60% of the total size of the global hedge fund industry. While small relative to the US mutual fund industry, the impact of hedge funds is magnified by the active trading and the use of leverage by some funds. Although hedge funds reportedly represent just 5% of all US assets under management, they are said to account for about 30% of all US equity trading volume. Until 2008, the hedge fund sector in the US had grown very rapidly. However, global market dislocations coupled with significant investor redemptions in 2008 have resulted in declines in both the number of hedge funds in the US as well as the size of assets under management.

16. What are the key statutes and regulations that govern hedge funds in your jurisdiction? What regulatory bodies are involved in regulating hedge funds?

In the US, the formation and operation of hedge funds, as well as the funds' investment activities themselves, are governed by numerous and varied statutes and regulations. This is not entirely surprising given the size of the industry, the range of different types of investors who invest in hedge funds, and the broad scope of activities in which hedge funds are engaged. Examples of US laws that potentially apply to hedge funds include:

- Federal and state securities laws.
- Investment adviser laws.
- Commodities regulations.
- Statutes governing pension money.
- Anti-money laundering rules.
- Privacy rules.
- Anti-takeover laws.
- Broker-dealer regulations.

The principal US federal securities laws include the:

- Securities Act.
- Exchange Act.
- Investment Company Act.
- Advisers Act.

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The primary regulatory bodies that are involved in regulating hedge funds include the:

- SEC.
- Commodity Futures Trading Commission.
- National Futures Association (NFA).
- FINRA.
- State-level securities regulators.

Numerous other governmental agencies, including the Treasury Department, engage in rule making and/or other policy initiatives that impact hedge funds and their operators.

17. How are the following areas regulated (if at all) in relation to hedge funds:

- **Risk.**
- **Valuation and pricing.**
- **Systems and controls.**
- **Insider dealing and market abuse.**
- **Transparency.**
- **Money laundering.**

- **Risk.** A number of the risks faced by hedge funds, such as market risk, liquidity risk and credit risk, are as a general matter not regulated but instead addressed primarily at the counterparty level. Other risks faced by hedge funds, such as certain operational risks, like valuation risk and system failures, are the subject of compliance-related requirements under the Advisers Act and NFA rules. In connection with offering interests in a hedge fund, the sponsor should disclose these risks to the extent they would be material to a reasonable prospective investor in the overall context of the offering.

- **Valuation and pricing.** Hedge fund managers that are registered investment advisers must maintain valuation procedures as part of their compliance policies (*Advisers Act*). US hedge funds, including those managed by advisers who are not registered, typically value their portfolios in accordance with US generally accepted accounting principles.

- **Systems and controls.** The SEC has stated that it expects hedge fund advisers to maintain written business continuity plans. NFA and FINRA rules require all member firms to maintain written business continuity and disaster recovery plans. Hedge fund managers that are registered investment advisers are required to adopt numerous written compliance policies and procedures covering a broad range of topics and to test the effectiveness of such policies and procedures (*Advisers Act*).

- **Insider dealing and market abuse.** It is prohibited to use material, non-public information to purchase or sell a security in breach of a fiduciary duty (*10b-5, Exchange Act*). In addition, hedge fund managers that are registered investment advisers must maintain written policies to prevent the misuse of material non-public information by the manager and its employees (*Advisers Act*).

- **Money laundering.** US hedge funds are required to comply with various US anti-money laundering rules and regulations as well as laws of certain jurisdictions where investments are offered, including the requirements of the US Treasury Department's Office of Foreign Assets Control. Proposed rules under the USA PATRIOT Act of 2001 that would have imposed additional procedural and due diligence anti-money laundering requirements on US hedge funds were withdrawn by the Treasury Department in 2008, although the general requirements continue to apply.

- **Transparency.** US hedge funds are subject to various disclosure requirements under US federal securities laws and other laws (*see Question 21*). Additional arrangements relating to transparency are agreed to by some hedge funds as a contractual matter with investors and various other counterparties.

18. Who can market hedge funds?

Interests in hedge funds in the US have historically been offered by the issuer (that is, the fund itself) and the fund's general partner in private placement transactions exempt from registration under the US federal securities laws. However, an increasing number of funds are engaging third-party solicitors to act on behalf of the fund in marketing and selling interests in hedge funds. Because most interests in hedge funds are considered to be securities for the purposes of US law, a person who markets hedge funds is likely to come within the ambit of:

- The broker-dealer rules of the Exchange Act.
- The regulations promulgated by the FINRA.
- State laws relating to broker-dealers and requiring hedge fund marketers to be registered as, or be associated with, a broker-dealer.

19. To whom can hedge funds be marketed?

In order to avoid the burdensome regulatory requirements which would otherwise be imposed on a hedge fund by the Securities Act and the Investment Company Act, offerings of interests in hedge funds in the US are typically structured to meet certain exemptions from these laws by requiring that investors in the fund meet certain eligibility requirements.

Regulation D promulgated under the Securities Act provides various safe harbours from securities registration for private offerings in which sales are made exclusively (or almost exclusively) to

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so-called accredited investors. Although changes to this definition have been proposed (*see Question 27*), for now, accredited investors include, generally speaking:

- High net-worth individuals who meet specified asset or income tests.
- Certain institutional investors.
- Certain trusts with assets of at least US$5 million (about EUR3.6 million).
- Certain retirement plans.

Section 3(c)(7) of the Investment Company Act is the most commonly relied on exemption from registration under the Investment Company Act. It excludes from the definition of investment company any issuer whose outstanding securities are owned exclusively by qualified purchasers. Generally speaking, a qualified purchaser is:

- A natural person who owns at least US$5 million in investments.
- A company or other entity that owns at least US$25 million (about EUR18 million) in investments.
- Certain trusts.

Many funds rely on section 3(c)(1) of the Investment Company Act which excludes from the definition of investment company any issuer whose outstanding securities are owned by not more than 100 beneficial owners.

If a hedge fund's general partner or investment adviser is registered under the Advisers Act, investors in a section 3(c)(1) fund must also generally be qualified clients in order for the general partner or adviser to be permitted to charge performance fees in respect of those investors. A qualified client generally includes a person or company with a net worth in excess of US$1.5 million (about EUR1.07 million) or that has US$750,000 (about EUR534,207) under management with the adviser.

20. Who holds the portfolio of assets? What regulations are in place for its protection?

A hedge fund's portfolio of assets is typically held by one or more prime brokers. Hedge fund managers that are registered investment advisers must maintain the fund's assets with a qualified custodian (for example a prime broker) and comply with a number of requirements intended to protect the fund's assets from loss, misuse or misappropriation (*Advisers Act*).

21. Describe the key disclosure or filing requirements (if any) that must be done by the fund (for example, in relation to the prospectus or offering memorandum and side letters).

Section 10(b) and Rule 10b-5 under the Exchange Act set out an overarching standard for the sale of securities, including in many cases interests in hedge funds. Under Rule 10b-5, in connection with the purchase or sale of any security:

- An issuer cannot make any untrue statement of a material fact.
- An issuer cannot omit a material fact necessary to make the statements made not misleading.

There are also similar state anti-fraud laws that may apply in certain circumstances. In addition, under the Advisers Act it is a fraudulent, deceptive or manipulative act for an adviser to a pooled investment vehicle (such as many hedge funds) to make any false or misleading statements or to omit any material fact to an investor or prospective investor in a pooled investment vehicle. Hedge funds typically disclose key business and legal information in an offering memorandum. Hedge fund managers should carefully review all marketing and offering materials to ensure that any required disclosures of material information (which could potentially include disclosure of certain side letters) comply with these requirements. Sensitive areas of disclosure include information regarding performance track record and conflicts of interest.

In addition, depending on their activities, US hedge funds and/or their managers may be required to make numerous other filings both at the federal and state levels. Examples of these filings include:

- Beneficial ownership reports required under various federal securities laws.
- Periodic positions reports. In 2008, new rules were adopted by the SEC to require periodic reporting of stocks sold short, in addition to the existing requirement to report periodically a fund's long positions.
- State securities filings.
- Adviser registration filings.
- Filings under anti-takeover laws.
- Disclosures relating to commodity-related activities.

22. What are the key requirements that apply to managers/operators of hedge funds?

Because a hedge fund's adviser is engaged in the business of providing investment advice for compensation, hedge fund managers are typically subject to the provisions of the Advisers Act. Hedge fund managers with fewer than 15 clients (with each hedge fund or account typically counting as one client) may be able to qualify for an exemption from the registration requirements of the Advisers Act, but there are still a number of important Advisers Act rules that apply to unregistered as well as registered investment advisers.

Investment advisers that are required to be registered under the Advisers Act are subject to numerous additional compliance obligations and are subject to periodic inspection by the SEC. Investment advisers may also be subject to registration and regulation

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at the state level unless federally registered. Managers of hedge funds that trade in commodities may be subject to regulation under the Commodity Exchange Act and may be required to register or qualify for an exemption from registration as a commodity pool operator and/or a commodity trading adviser.

23. What are the main legal vehicles used to set up a hedge fund and what are the key advantages and disadvantages of using these structures? What are the participants' interests in the fund called (for example, share or unit)?

In the US, hedge funds are typically formed as Delaware limited partnerships under the Delaware Revised Uniform Limited Partnership Act (*6 Del C § 17-101, et seq*) (DRULPA). A limited partnership formed under the DRULPA offers investors the advantages of limited liability as well as flow-through tax treatment in the US. Each investor in the fund is typically a limited partner and its interest is a limited partnership interest. The liability of a limited partner is generally limited to the amount of capital that has been contributed or that has been agreed to be contributed (or returned) by the limited partner.

Some hedge funds formed in the US are formed as Delaware limited liability companies (LLCs) under the Delaware Limited Liability Company Act (*6 Del C § 18-101, et seq*) (DLLCA). Each investor in a fund formed as an LLC is typically a member and its interest is an LLC interest. LLCs formed under the DLLCA offer investors similar limited liability and flow-through US tax treatment as are enjoyed by investors in hedge funds formed as limited partnerships.

24. What are the advantages and disadvantages of using onshore and offshore structures?

Onshore

Onshore structures typically offer the advantages of:

- Familiarity for US investors.
- Limited liability.
- Flow-through tax treatment.

Disadvantages include potential negative tax consequences for non-US investors and, in some circumstances, US tax-exempt investors (*see Question 25*).

Offshore

Offshore structures typically offer the advantages of:

- Familiarity for certain non-US investors.
- Limited liability.
- Avoidance of certain potentially negative tax consequences for non-US and US tax-exempt investors.

Disadvantages include additional structuring and/or complexity needed to be able to obtain capital gain tax treatment for the fund's sponsor in respect of the performance compensation or allocation charged in respect of the offshore fund. In 2008 changes to the US Internal Revenue Code were enacted to limit significantly the ability of US hedge fund manager to defer paying tax on compensation earned in respect of offshore funds.

25. Describe the tax treatment for:

- **Funds.**
- **Resident investors.**
- **Non-resident investors.**

- **Funds.** A hedge fund formed in the US as a limited partnership or an LLC, and that is taxed as a partnership for US federal income tax purposes, is not generally subject to tax with respect to its income or gains. That is, there generally is not an entity level tax on the fund itself. Instead each investor in the fund would be required to take into account its distributive share of each item of the hedge fund's income, gain, loss or deduction. In order to preserve this pass through tax treatment at the fund level, the fund must not be deemed to be operating as a publicly traded partnership (PTP) as defined under the US Internal Revenue Code. If a hedge fund operates as a PTP, the fund could be classified as an association taxable as a corporation and therefore subject to entity level tax.

- **Resident investors.** A US investor that invests directly into a US hedge fund that is a pass-through vehicle for US federal income tax purposes is required to take into account its distributive share of each item of the hedge fund's income, gain, loss or deduction. Special tax rules apply to US tax-exempt investors, such as endowments, foundations and pension plans, which generally are required to pay tax on and make tax filings in respect of their distributive share of any unrelated business taxable income (UBTI). Because the activities of hedge funds may be likely to generate UBTI, US tax-exempt investors may seek to invest in a parallel or feeder offshore hedge fund organised as a corporation, since UBTI generated by the fund's activities would be blocked by and not flow up to the investors in an offshore corporate fund.

- **Non-resident investors.** A non-US investor that invests directly into a US hedge fund that is a pass through vehicle for US federal income tax purposes is subject to:

  - US federal income tax and return filing obligations on income that is effectively connected with the conduct of a trade or business within the US (known as effectively connected income (ECI));
  - withholding by the fund in respect of ECI as well as certain other US source income of the fund that is not ECI attributable to the non-US investor;

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- annual disclosure of the investor's identity to the US Internal Revenue Service (IRS) when the hedge fund files Schedule K-1s with the IRS for each of its investors.

To avoid these consequences, many operators of US hedge funds establish offshore funds that invest in parallel with the US hedge fund (or that serve as a feeder into a master fund) and into which non-US investors can invest.

26. Can participants redeem their interest? Are there any restrictions on the right of participants to transfer their interests to third parties?

Although investors in US hedge funds do not typically enjoy the same liquidity as investors in US retail/mutual funds, investors in US hedge funds typically have the right to redeem or withdraw their interests on a periodic basis (for example, monthly, semi-annually or annually). Many funds impose an initial lock-up period during which redemptions from the fund are not permitted. Some hedge funds limit the total amount of redemptions permitted at any one time. While redemptions have usually been paid in cash, many hedge funds have the flexibility to redeem in-kind by distributing fund investments.

In addition, operators of certain hedge funds can suspend redemptions under certain specified circumstances (for example, when it is not possible to price the fund's portfolio). Suspensions and redemptions in kind occurred with increased frequency in 2008 as a result of the impact on hedge funds of the significant turmoil in the global financial markets. The redemption features of a given hedge fund are often related to the liquidity of the underlying investment strategy and therefore the fund's ability to satisfy redemption requests by liquidating assets. Hedge fund investors are commonly required to provide prior written notice of any redemption request.

Transfers of interests in US hedge funds typically require the prior written consent of the fund's general partner or manager. There are a number of important legal, tax and commercial reasons for the operator of the hedge fund to retain control over transfers of interests in the fund to third parties.

27. Please summarise any proposals for the reform of hedge fund regulation in your jurisdiction.

The SEC has proposed a number of important changes to the commonly used Regulation D private placement safe harbour under the Securities Act (*see Question 19*), which would, among other things:

- Heighten the investor qualification standards for individuals seeking to invest in private investment funds (such as hedge funds) that rely on the 3(c)(1) exemption from the Investment Company Act by imposing a new more onerous accredited natural person test.

- Apply a bad actor disqualification provision to all offerings under Regulation D. This would prevent an issuer from relying on the exemption if the issuer or certain affiliated persons violated certain laws.

Additional legislative initiatives that would affect hedge funds include proposals to:

- Increase the US federal income taxes paid by US hedge fund managers in respect of their carried interest incentive allocation.

- Require registration of hedge fund managers as investment advisers under the Advisers Act.

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