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Alternative Funds 2022

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USA

Law and Practice

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1. General

1.1 General Overview of Jurisdiction

In general, due to its importance in the global economy and financial markets and the extensive regulatory and legal framework that has built up over time, the United States is a major jurisdiction for alternative funds and their managers and investors. Specifically, Delaware is the most popular jurisdiction to form domestic hedge funds due to its well-developed statutory regime and comprehensive body of case law.

At the end of 2019, in which the US GDP amounted to USD21.43 trillion, there were over 32,000 alternative funds, with more than 3,100 managers and USD9 trillion in assets under management (which notably does not take into consideration the significant leverage utilised by many alternative funds).

2. Funds

2.1 Types of Alternative Funds

The typical types of alternative funds established in the United States consist of:

- hedge funds;
- private equity funds;
- real estate funds;
- credit funds; and
- hybrid fund types.

Open-End Funds/Strategies

The principal types of hedge funds are:

- global macro;
- equity (eg, long/short, long-biased);
- relative value (eg, market neutral, capital arbitrage, convertible arbitrage);
- credit (eg, long/short credit, fixed income, MBS, ABS);
- event-driven (eg, activist, distressed debt, merger arbitrage);
- managed futures;
- multi-strategy;
- litigation finance; and
- cryptocurrencies and other digital assets.

Closed-End Funds/Strategies

Strategies pursued by closed-end funds are generally more illiquid in nature and include private equity investments, real estate (including development), direct lending, distressed debt and infrastructure.

Credit Funds

Credit funds embrace many distinguishable investment strategies, such as capital preservation strategies (eg, those employed by mezzanine and direct lending funds), return maximising strategies (eg, those employed by distressed debt, corporate credit and opportunistic/special situation funds) and specialty finance or other niche strategies. There are also a number of credit managers that build “dislocation funds” (eg, commitment funds where the committed capital is not drawn down until a certain trigger event occurs – eg, a certain high-yield spread is reached). Credit funds can be structured as hedge funds, private equity-style funds or a combination of both (eg, a “hybrid fund”).

Hybrid Funds

Hybrid funds are customised fund structures, often with closed-end features and “private equity lite” terms that help capture a broader range of investment opportunities. Hybrid funds are designed to hold a blend of both liquid and illiquid assets.

2.2 Fund Structures

An alternative fund's structure is shaped by tax, regulatory and other considerations, such as the investor base, the jurisdictions involved and the investment programme. For example, US and non-US investors face different tax considerations, while investors who are generally exempt from US income tax may have different tax sensitivities from those investors who generally pay US tax on their income. Thus, funds are often structured to allow different types of investors to invest in different ways that address their specific concerns.

Fund structures include standalone funds, side-by-side funds, master-feeder structures and "mini-master" structures. Fund structures may also include alternative investment vehicles, parallel funds, special purpose vehicles (SPVs) and blocker corporations. The most common structure, particularly for taxable US investors, is the limited partnership, although other types of vehicles, including limited liability companies, may be used.

Entity Type

US funds are often formed as limited partnerships or limited liability companies (LLCs), which offer limited liability to their limited partners or non-managing members, as well as "flow-through" tax treatment to such investors. Certain types of investors may prefer to invest in non-US funds that are treated as corporations for US tax purposes, which do not offer flow-through tax treatment.

State Formation

US investment partnerships are commonly formed under the laws of the State of Delaware. Delaware corporate statutes are well developed and offer flexibility. There is a comprehensive body of law in Delaware relating to corporations, partnerships and LLCs, as well as related areas affecting alternative funds.

Specialised Structures

Variations on core structures may be used to provide investors with access to certain strategies in a tax-efficient manner, subject to special sets of rules and guidelines. For example, an insurance-dedicated fund is a specialised type of fund that is used to support privately placed life insurance and annuity contracts, which may provide tax deferral or elimination for holders of the underlying insurance policies or annuity contracts. Real estate investment trusts may provide a tax-efficient structure for investing in eligible real estate assets.

2.3 Funds: Regulatory Regime

Registration Requirements

Typically, private funds are structured in a manner that does not require federal registration as investment companies. It should be noted that this chapter concerns unregistered products as opposed to registered funds such as mutual funds. The managers of private investment funds may need to be registered as investment advisers under federal or state securities laws. Several primary federal laws are set forth below.

The Securities Act of 1933

The Securities Act regulates the offer and sale of securities in the United States, including the offering of interests and shares by alternative funds. Section 5 of the Securities Act requires that securities offered or sold in the United States or to US persons must be registered with the Securities and Exchange Commission (SEC), unless they are offered or sold in reliance on an exemption from registration.

Offers and sales by alternative funds are typically made under Rule 506 of Regulation D as a "safe

harbour" from registration under the Securities Act. Rule 506(b) offerings are exempt if, among other things, offers and sales are not made using general solicitation or general advertising and all purchases (except for up to 35 purchasers) are "accredited investors", as described below. Similar to Rule 506(b), Rule 506(c) offerings are exempt if all purchasers are accredited investors (there is no exception for non-accredited investors). Rule 506(c) does not prohibit the use of general solicitation or general advertising. Additionally, an alternative fund relying on Rule 506(c) is subject to heightened verification requirements regarding the accredited investor status of each investor, requiring the alternative fund to take "reasonable steps" to verify each investor's accredited investor status.

Regulation S

Regulation S provides a safe harbour for alternative funds by generally exempting offers and sales of securities conducted outside the United States from the requirements of Section 5 of the Securities Act if:

- the offer and sale are made in an offshore transaction; and
- the alternative fund, a distributor or its agents do not engage in directed selling efforts within the United States.

Regulation S also offers a safe harbour to offshore resales by parties other than the alternative fund or its affiliates.

The Investment Advisers Act of 1940

See **3.2 Managers: Regulatory Regime**.

The Investment Company Act of 1940

The Investment Company Act regulates investment companies in the United States. Generally, alternative funds that invest in securities would be considered investment companies under the Investment Company Act. An "investment company" is an issuer that is, or holds itself out as being, engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities.

Sections 3(c)(1) and 3(c)(7) of the Investment Company Act exempt qualifying alternative funds from the definition of "investment company" and therefore relieve the funds from many Investment Company Act requirements.

The Commodity Exchange Act (CEA)

The CEA is a federal statute that regulates the commodity futures and derivatives markets in the United States. The primary regulator of commodities and futures in the United States is the Commodity Futures Trading Commission (CFTC).

The CEA and rules promulgated thereunder by the CFTC may be relevant to alternative funds that engage in cryptocurrency trading, or quantitative and algorithmic trading, as well as other funds that trade in those markets.

The Employee Retirement Income Security Act of 1974 (ERISA)

ERISA is a federal law that regulates voluntarily established retirement and health plans for private businesses. If 25% or more of the class of interests of a fund are owned by employee benefit plan investors, such as an employer-sponsored 401(k) plan or individual retirement account, all of the assets of the alternative fund will be deemed ERISA plan assets and the alternative fund's manager will be required to comply with ERISA's fiduciary responsibility provisions. In addition, the alternative fund will be required to comply with certain prohibited transaction provisions under both ERISA and the US Inter-

nal Revenue Code of 1986, as amended (the "Code").

Blue Sky Laws
Alternative funds are also required to comply with applicable state securities laws ("blue sky laws") and regulations. For example, an alternative fund offering its interests pursuant to the registration exemption under SEC Rule 506(b) may be required to make "notice filings" in a state where the alternative funds securities are sold.

Investment Limitations
Generally, there are no applicable laws that limit the amount of an investment in an alternative fund. However, there are investor-based qualifications that alternative funds must meet in order to invest in certain products and engage in certain transactions. For example, an alternative fund must be a "qualified institutional buyer" in order to purchase SEC Rule 144A restricted securities, and must be an eligible contract participant as defined by the CEA to engage in certain over-the-counter derivative transactions.

2.4 Loan Origination
Fund managers should analyse all aspects of their lending businesses, each of which may be subject to different regulatory regimes. For example, a loan origination entity may be regulated under the broker-dealer rules of the Exchange Act. In addition, direct lending funds must be structured to comply with investment adviser rules, CEA regulations and, on occasion, ERISA.

Tax Considerations
A fund that originates loans in the United States on a regular basis is generally considered to be engaging in a US trade or business for US tax purposes, which may result in adverse US income tax consequences and filing requirements for non-US investors. The US federal, state and local tax considerations with respect to originating loans in the United States are complex.

Activities of a fund, such as loan origination activities or business operations, may cause non-resident investors to be subject to tax in a jurisdiction where the fund operates. Moreover, certain jurisdictions may impose withholding obligations on domestic funds participating in such activities, and other jurisdictions may impose an entity-level tax on such business activities (for example, New York City's 4% unincorporated business tax).

Licensing and State Usury Law Considerations
Fund managers must consider such issues as licensing and state usury laws that may impose limits on the permissible amount of interest that can be charged on a commercial loan. With respect to licensing, fund managers must analyse all relevant factors to determine whether a state commercial lending licence is needed with respect to any given transaction. This typically includes an analysis of:

- the location of the borrower;
- the location of the lender;
- the location of the collateral;
- the place from which the loan proceeds will be originated;
- policy considerations; and
- applicable state law.

If licensing is required, information concerning the fund, its affiliates, its owners and its business plan is often necessary.

2.5 Non-traditional Assets

Funds can invest in non-traditional assets; please see examples below.

Cryptocurrency/Digital Assets

Funds may be focused on cryptocurrency and digital assets (such as bitcoin and ether). Cryptocurrency funds can take a number of forms, ranging from simple "wallet" funds (eg, a fund that invests in cryptocurrency and pays cash back to investors when they decide to redeem) intended to provide a custody solution for holding a particular currency to discretionary investment strategies that trade in multiple currencies, strategies investing in blockchain, venture companies, or a combination of these strategies. Depending on the mix of investments and approaches, cryptocurrency funds may be structured as hedge funds with side pocket mechanisms or as private equity-style venture capital funds. A fund invested in cryptocurrency and digital assets must contend with certain regulatory regimes and difficulties caused by the fact that this is still a developing area. For example, there is the question of which digital currencies are "securities". The CFTC has asserted jurisdiction over pure play digital currencies, such as bitcoin, whereas the SEC has asserted jurisdiction over "digital coins" or "digital tokens".

If a fund manager is advising others on trading digital assets that are securities, it may have to register with the SEC as an investment adviser. If a manager is required to register, it will have to comply with the Custody Rule, which requires client funds and securities to be maintained with qualified custodians in an account either under the client's name or under the name of an agent or trustee of the client. For registered investment advisers operating in the cryptocurrency space, compliance with the Custody Rule can be a technical challenge, especially if the sponsor plans to invest in some of the newer cryptocurrencies, the protocols of which are not supported by regulated, established custodians. See **2.9 Rules Concerning Other Service Providers** (Custody Rule).

A further challenge for sponsors in this space is the issues around the tax treatment of cryptocurrencies and other digital assets, which again stem from the uncertainty of the treatment of particular investments as "securities", "currencies" or "property". For example, certain digital assets may be treated as property, not currency, for US federal tax purposes. Although the Internal Revenue Service has issued some guidance, many uncertainties remain as to the tax treatment of digital assets. While affecting all types of investors to varying degrees, the US tax considerations may be particularly adverse for non-US investors, and as a result could disadvantage US-based sponsors looking to manage non-US investor capital.

Litigation Finance

Litigation finance funds may provide capital to law firms and various types of organisations involved in legal disputes. Interest in private funds focusing on litigation finance has continued to grow in 2022, and a substantial number of private equity-style funds have been raised to pursue this strategy, as well as existing funds with broad opportunistic mandates pursuing litigation finance as a sub-strategy. There are a variety of ways in which such investments may be structured, which present different tax considerations depending on the types of investors in such funds. The regulatory issues associated with this type of investing require sophisticated expertise targeted at the locality in which the opportunity is based and from which investment decisions are made.

Music Catalogues

Private funds investing in music catalogues are another segment of the industry receiving increased attention. One reason for this seems to be the evolution of music-streaming services, which has created a mechanism for owners to capture licensing fees each time a particular song is played. Fund sponsors have launched private equity-style funds to acquire music properties and take advantage of this streaming revenue. The recurring nature of these fees makes these catalogues an appropriate product for syndicated asset-based financing offerings.

2.6 Regulatory Approval Process

Alternative funds are structured to be exempt from registration requirements under both US securities and commodities laws and therefore are not typically required to obtain prior regulatory approval before issuing securities. Alternative funds that rely on a safe harbour exemption under Regulation D must make a regulatory filing with the SEC on Form D within 15 days of the first sale of the fund interests or shares. Many US states also require "notice filings" to be made in connection with the sale of fund interests within their jurisdictions.

2.7 Requirement for Local Investment Managers

There is no requirement under federal or state law that a US fund must have a US investment manager.

2.8 Other Local Requirements

Generally, there are no US legal requirements governing the appointment of directors, employees or business premises.

However, when formed under the laws of a particular US state (eg, Delaware), an alternative fund is subject to all applicable laws concerning its legal form, including those related to formation, governance, rights of interest holders, and mergers, consolidations and dissolution. In addition, nearly all US states require alternative funds to maintain a registered office or a registered agent in the state where the alternative fund is formed.

2.9 Rules Concerning Other Service Providers

Generally, alternative funds and their investment advisers have broad discretion to select service providers to appoint on behalf of the alternative fund. Where an alternative fund retains a service provider, the fund and its manager are responsible for the provider's regulatory compliance.

Custody Rule

Most alternative fund managers have, or are deemed to have, "custody" of the alternative fund's assets and are therefore subject to the SEC's Custody Rule, which requires a fund manager to place a fund's securities with "qualified custodians", including US-regulated banks or US-registered broker-dealers, and non-US financial institutions that keep clients' assets in customer accounts segregated from its proprietary assets.

Many alternative fund managers choose to comply with the Custody Rule requirements by delivering annual audited financial statements to fund investors within 120 days of the end of the fund's fiscal year (180 days for funds of funds), and the auditor must be registered with, and subject to examination by, the Public Company Accounting Oversight Board.

2.10 Requirements for Non-local Service Providers

There are no legal or regulatory requirements applicable to non-local service providers.

2.11 Funds: Tax Regime

In general, there is no entity-level US federal income tax on domestic funds that are treated as partnerships for US federal income tax purposes. Instead, each partner of such a fund reports on its own annual tax return such partner's distributive share of the fund's taxable income or loss. Such amounts are reported to investors by the fund on an Internal Revenue Service Schedule K-1.

If a fund that is organised as a partnership were to be treated as a "publicly traded partnership" (PTP) taxable as a corporation for US federal tax purposes, then the taxable income of the fund would be subject to corporate income tax when recognised by the fund. Distributions of income, other than in certain redemptions of interests, would be treated as dividend income when received by the investors to the extent of the current or accumulated earnings and profits of the fund, and investors would not be entitled to report profits or losses realised by the fund. A fund organised as a partnership may need to follow certain limitations on the number of investors, the type of income it has each tax year, or the frequency of permissible withdrawals and transfers in order to ensure that it is not treated as a PTP taxable as a corporation for US federal tax purposes.

2.12 Double-Tax Treaties

Utilisation by Investors

US funds that are treated as partnerships for US federal income tax purposes do not generally qualify at the entity level for benefits under a tax treaty with the United States; however, their "flow-through" status may allow non-US investors located in jurisdictions that have such a tax treaty to claim treaty benefits (which may include a reduction in, or complete exemption from, the 30% US withholding tax on certain types of US-source income). In order to establish eligibility to claim tax treaty benefits, a non-US investor will typically be required to provide an applicable Internal Revenue Service Form W-8, and may be required to make certain other certifications.

Structuring Issues

Certain jurisdictions, such as Canada and the UK, may limit the availability of tax treaty benefits for a resident of those jurisdictions investing in a fund that is organised as an LLC rather than as a limited partnership. A US fund that is anticipating non-US investors may prefer to be organised as a limited partnership rather than an LLC.

2.13 Use of Subsidiaries for Investment Purposes

Funds may form subsidiaries from time to time for various purposes, including to make or hold a particular investment or investments, to obtain financing in connection with its investments or to facilitate the distribution of investments in kind. Such SPVs may be used for the benefit of one or more funds (for instance, to facilitate the sharing of a particular asset across multiple funds via the use of participations). Tax considerations are important when structuring a subsidiary and may also be the main impetus for why subsidiaries are used. For example, subsidiaries organised in appropriate jurisdictions may reduce or eliminate certain non-US taxes for certain US investors.

2.14 Origin of Promoters/Sponsors of Alternative Funds

Because US investors are a significant presence in all types of investment funds, managers from around the world may choose to create US-domiciled vehicles to accommodate them.

2.15 Origin of Investors in Alternative Funds

Typically, investors in US alternative funds are US taxable and tax-exempt investors, although investors in US funds increasingly include those from other jurisdictions. See also **4.1 Types of Investors in Alternative Funds**.

2.16 Key Trends

Hedge Funds

In 2020, the winning category among hedge funds was equities, delivering some +19.7%, according to Preqin. Within equities, funds pursuing investments in the technology, healthcare, and energy and basic materials sectors excelled. Other event-driven and certain niche strategies also performed well. Credit was the laggard hedge fund strategy, relatively speaking.

In 2020, the hedge fund fundraising environment was more skewed in favour of established firms that reopened previously closed funds to replace outflows or performance-based declines or to build war chests to pursue specific opportunities, or that raised new, customised or bespoke products alongside their flagship funds (eg, more concentrated "best ideas" funds, long-only or long-biased funds, funds that offer exposure to a specific subset of a flagship fund's investment strategy, or other variations, such as funds with narrower geographic mandates, or sleeves within existing fund complexes). In 2021, there were more emerging manager launches, especially those targeting niche strategies that were not overcrowded, such as the cryptocurrency and/or blockchain space, healthcare and pro-diversity governance strategies.

Private Equity

Private equity fund sponsors also raised significant capital in 2020 and 2021, with Preqin reporting some USD188 billion raised across 452 funds in the first quarter of 2021, up from USD163 billion and 431 funds in Q1 2020. In terms of investment focus and investor demand, private equity funds are targeting industries that were particularly hard hit by, and related to, COVID-19, such as airlines, hospitality, fintech and commercial real estate, with continued interests in the illiquid investments held by core real estate funds and other long-term or perpetual fund structures. There have been investment opportunities in a variety of other real estate sectors – such as logistics, self-storage and data centres – and investors are exploring opportunities for repurposing retail properties for alternative uses.

General Partner (GP)-Led Secondaries

A vast amount of activity continues to be seen in the market for GP-led secondary transactions with respect to interests in private equity funds and single investment funds, and even certain hedge funds offering tender offer-style liquidity to investors. The COVID-19 dislocation may have created more assets experiencing unexpected illiquidity that would be promising targets for this type of approach.

Hybrid Funds

There has also been increasing use of "hybrid funds" designed to hold a blend of liquid and illiquid assets, and invest across public and private equity markets, which raises unique issues relating to taxation, trade allocations, conflicts of interest and valuations.

Environmental, Social and Governance (ESG)

Private fund managers across strategies and structures are facing increasing demands with respect to the integration of ESG principles into investment programmes. The more recent development in this area has been a focus on diversity, equity and inclusion, both at the investment

level and at the level of the manager's own operations. In May 2022, the SEC proposed rules (the "Proposed ESG Rules") to facilitate enhanced disclosures regarding investment advisers' and investment companies' incorporation of ESG factors into their advisory services and strategies. While the bulk of the Proposed ESG Rules apply to registered investment companies, unit investment trusts and business development companies, the Rules would require investment advisers to provide additional disclosures in Form ADV regarding their ESG investing approach by strategy, certain relationships with related persons, and any ESG-related impacts on proxy voting.

Enhanced US Federal Regulation

On 9 February 2022, the SEC proposed a series of new rules and amendments to existing Advisers Act rules applicable to private fund managers (the "Proposed Private Fund Rules"). The Proposed Private Fund Rules seek to, among other things:

- require specified and standardised quarterly disclosures regarding performance, fees and expenses;
- prohibit private fund managers from engaging in certain activities;
- require disclosure of, and in some cases limit, preferential treatment provided to certain private fund investors;
- require that all private funds be subject to annual audit;
- add a written documentation requirement for annual reviews; and
- create requirements to keep records of compliance with the Proposed Rules.

Certain of the Proposed Private Fund Rules apply only to SEC-registered investment advisers to private funds, while others apply to all investment advisers to private funds, even when such advisers are not SEC-registered.

2.17 Disclosure/Reporting Requirements

Disclosure requirements are specific to the type of alternative fund, whether its manager is registered as an investment adviser with the SEC, its asset type(s) and its investor make-up. See **2.3 Funds: Regulatory Regime** and **3.2 Managers: Regulatory Regime**.

In general, an alternative fund's offering documents should contain adequate regulatory disclosure. They should include disclosures regarding, for example, performance-based compensation, certain conflicts of interest, allocations of investments, co-investments, the use of "soft dollars", withdrawal rights (to the extent applicable), certain preferential rights that may be granted to investors, and/or principal transactions.

If a manager is registered as an investment adviser with the SEC, it must file certain periodic reports with the SEC with respect to the funds it manages or advises. All registered advisers must file Form ADV, which contains private fund-specific disclosures, including fund type (eg, hedge, private equity), assets under management, aggregate investor totals and composition by investor type, and data on service providers used by the fund – see **3.2 Managers: Regulatory Regimes** (Registration Process). Additionally, certain registered advisers must complete Form PF filings, which contain more detailed information on the funds they manage or advise than is disclosed in Form ADV. Form PF is required to be filed on an annual or a quarterly basis, with more frequent filings required for larger private fund advisers.

Advisers that are registered as commodity pool operators (CPOs) or commodity trading advisers (CTAs) must deliver to each prospective investor a "Disclosure Document" no later than the time when they deliver the subscription agreement. See **3.2 Managers Regulatory Regimes** (Commodity Exchange Act).

See also **4.3 Rules Concerning Marketing of Alternative Funds** (in particular, discussions of Regulation D and Marketing Rule requirements).

2.18 Anticipated Changes

There are no forthcoming changes that are likely to change the above responses. That being said, it is typical for the SEC and CFTC to regularly propose amendments to their regulatory and implementing strategies that may have effects on the regulatory regime described in **2.3 Funds: Regulatory Regime**.

3. Managers

3.1 Legal Structures Used by Fund Managers

Management companies are often formed as limited partnerships, with an LLC serving as the GP and other persons involved in management admitted as limited partners.

US funds often have a separate GP that receives a performance allocation or carried interest. As such, this entity makes a capital contribution to the fund. The GP may be formed as an LLC.

3.2 Managers: Regulatory Regime

The Investment Advisers Act of 1940 (the "Advisers Act")

Registration requirement

The SEC regulates investment advisers primarily under the Advisers Act and rules adopted thereunder. An alternative fund manager that meets the definition of "investment adviser" under the Advisers Act must generally register with the SEC. An investment adviser is defined as "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

Alternative fund managers are generally presumed to be acting as investment advisers and will be required to register with the SEC unless an exemption is available. Other investment advisers may be required to register with one or more US state securities regulatory authorities or the SEC, depending upon the amount of their regulatory assets under management and whether the investment adviser has a principal place of business inside or outside the United States.

Exempt reporting advisers

An alternative fund manager may be able to claim an exemption from registration with the SEC as an "exempt reporting adviser" if it meets the following criteria:

- the manager solely advises private funds (meaning funds that are excluded under Section 3(c)(1) or 3(c)(7) of the Investment Company Act) and manages regulatory assets under management of less than USD150 million; or
- the manager solely advises one or more "venture capital funds", as defined under SEC rules.

In order to claim exempt reporting adviser status, a manager must file an abbreviated version of Form ADV and report information, including information about the funds it advises, other business activities and any personnel disciplinary disclosures. Non-US advisers may also file as exempt reporting advisers with the SEC under certain conditions.

Exempt reporting advisers are subject to certain limited regulatory requirements, including the requirement to have policies and procedures reasonably designed to address the general anti-fraud provisions and the SEC Pay to Play Rule, and to guard against the misuse of material non-public information.

Alternative fund managers based outside the United States may be exempt from registration if they qualify as a "foreign private fund adviser". A non-US fund manager may qualify as a foreign private fund adviser if it:

- has no place of business in the United States;
- has fewer than 15 clients in the United States and US investors in the private funds it advises;
- has less than USD25 million in aggregated assets under management attributable to US clients and investors; and
- does not hold itself out to the public in the United States as an investment adviser, nor acts as an investment adviser to a registered investment company or a business development company.

Unlike exempt reporting advisers, foreign private fund advisers are not subject to SEC regulation and are not required to file any reports with the SEC.

Registration process

If an alternative fund manager has the requisite amount of regulatory assets under management or is a non-US adviser that does not qualify for any of the exemptive statuses set forth above, it will be required to register with the SEC as an investment adviser.

Alternative fund managers required to register with the SEC must do the following.

- File Form ADV with the SEC. Form ADV must be amended on an annual basis within 90 calendar days of fiscal year-end, and on an other-than-annual basis upon the occurrence of certain developments (ie, the departure of a control person or reporting a disciplinary proceeding). Form ADV consists of three parts: Part 1 requires the investment adviser to input information about its business (such as location, ownership structure and amount of regulatory assets under management) into a standard form and is publicly available; Part 2 requires the investment adviser to prepare a brochure that describes in plain English its business, conflicts of interest, certain advisory personnel and the risks associated with the investment strategies employed by the investment adviser; Part 3 (which is not required to be filed by investment advisers that solely advise alternative funds or that have no natural persons as clients) requires the preparation of a client relationship summary (Form CRS). See **2.17 Disclosure/Reporting Requirements**.
- Act as a fiduciary to all clients, which includes a duty of loyalty and a duty of good faith. Investment advisers must provide to current and prospective investors full and fair disclosure of all material facts and conflicts of interest associated with an investment in an

alternative fund managed by the investment adviser.
- Adopt, maintain and periodically review written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and related regulations, and have a code of ethics governing employee behaviour (including policies and procedures to address personal trading reporting and restrictions, the receipt of material non-public information, and enforcement of insider trading procedures).
- Maintain books and records for specified periods of time, as set forth in SEC Rule 204-2.
- Comply with the SEC's rules pertaining to the marketing and advertising of alternative fund interests (see **4.3 Rules Concerning Marketing of Alternative Funds**).
- Only charge performance-based fees to alternative fund investors that are considered to be "qualified clients" under SEC Rule 205-3.
- If a US alternative fund manager does not have the requisite amount of assets under management, it will need to register with, or seek exemptions from, regulatory authorities in states in which it operates. State regulatory regimes often have similar requirements to those of SEC-registered advisers.

Commodity Exchange Act

Registration requirements

Managers that advise or manage alternative funds that trade in exchange-traded futures contracts, options, swaps and/or any other commodity interests regulated under the CEA (referred to as a commodity pool) are required to register as a CPO and/or a CTA, and become a member of the National Futures Association (NFA), the US self-regulatory organisation for the futures industry, unless an exemption from registration applies.

A CPO is defined as any person generally "engaged in a business which is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests", with some exceptions.

A CTA is defined as "any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings or electronic media, as to the value of or the advisability of trading" in commodity interests, with some exceptions.

An alternative fund that is a commodity pool will generally have one or more CPOs and/or CTAs (whether registered or exempt). Where the amount of trading in commodity interests by an alternative fund is limited in accordance with CFTC regulations, its manager may seek exemptive relief from registering as a CPO and/or CTA.

Exemptions from CFTC registration

Whether a manager with US customers is required to register as a CPO generally turns on the amount of commodity interest trading in its managed pools. Managers that operate only pools for sophisticated investors with "de minimis" exposure to commodity interest trading, as defined under CFTC Rule 4.13(a)(3), are not generally required to register as CPOs, provided that a suitable exemption notice is filed with the NFA and appropriate investor disclosures are made. (Offshore managers operating offshore pools for non-US investors may be able to claim a jurisdictional exemption under CFTC Rule 3.10(c).)

By contrast, whether a manager is required to register as a CTA generally turns on the number of commodity interest advisory clients that it serves (a fund being deemed a single client). US managers with 15 or fewer such advisory clients are not required to register as a CTA per CFTC Rule 4.14(a)(10), provided that the manager does not generally hold itself out to the public as a CTA. This count excludes pools for which the manager already serves as the CPO of record pursuant to CFTC Rules 4.14(a)(4) and (5); non-US managers may also exclude their non-US clients from the count. Other exemptions may apply to winnow the count further. Notably, as CFTC Rule 4.14(a)(10) is a "self-executing" exemption, most fund managers are automatically exempt from CTA registration. Managers with many separately managed accounts, or many sub-advisory relationships, may need to consider this question closely.

Registering as a CPO or a CTA

For managers who must register with the CFTC, the registration process is handled by the NFA. Both registered CPOs and CTAs are subject to CFTC rules and regulations that mandate specific disclosures to alternative fund investors, which include the alternative funds investment strategy regarding the commodities, general information about the CPOs and the CTAs associated with the alternative funds, principal risk factors, and conflicts of interest. CPOs and CTAs are also subject to the CFTC's and NFA's periodic reporting requirements to investors and are required to keep specific records.

Registered CPOs and CTAs are also subject to compliance with NFA rules that specify a number of compliance obligations, including rules regarding the use of marketing materials, specific requirements regarding the calculation and presentation of performance information, and rules regarding the creation of written business continuity and disaster recovery plans.

CFTC Rule 4.7 – "Registration Lite"

A registered CPO that manages or advises an alternative fund in which all investors are qualified eligible persons (defined to include qualified purchasers) may claim exemptive relief under CFTC Rule 4.7, which provides relief from compliance with certain detailed disclosure, reporting and record-keeping requirements. CPOs seeking to rely on Rule 4.7 must file a notice of claim of exemption with the NFA and provide certain "boilerplate" investor notices.

A parallel exemption under Rule 4.7 is available for registered CTAs, which similarly obviates various detailed brochure and record-keeping requirements, contingent on a notice of claim of exemption being filed with the NFA and certain boilerplate investor notices being made.

Securities and Exchange Act of 1934

Broker-dealer registration

Generally, individuals or entities that engage in the business of effecting securities transactions in the United States or for US persons are required to register with the SEC as broker-dealers and become members of the Financial Industry Regulatory Authority (FINRA).

However, the SEC has indicated that an investment adviser, such as a manager of an alternative fund, is not required to register as a broker-dealer, provided that the investment adviser:

- does not receive transaction-based compensation;
- executes trades through a registered broker-dealer; and
- does not hold client funds or client securities.

Section 13 public reporting
Managers may be subject to Section 13 public reporting requirements if they:

- beneficially own more than 5% of a class of a certain public company's voting equity securities (Schedule 13D or 13G);
- manage discretionary accounts that, in aggregate, hold USD100 million or more in certain securities (as defined by the SEC) (Form 13F); and
- manage discretionary accounts trading in national market system (NMS) securities that (i) transact in NMS securities equal to or exceeding 2 million shares or USD20 million during any calendar day or (ii) transact in NMS securities equal to USD200 million during any calendar month (Form 13H).

Privacy and cybersecurity
Gramm-Leach-Bliley Act (GLBA) Regulation S-P and Regulation S-ID provide specific rules requiring how managers handle non-public personal information. Regulation S-P requires that a manager's written policies and procedures are reasonably designed to:

- ensure the security and confidentiality of customer records and information;
- protect against any anticipated threats or hazards to the security or integrity of customer records and information; and
- protect against unauthorised access to, or use of, customer records or information that could result in substantial harm or inconvenience to any customer.

Regulation S-ID requires managers to implement an identity theft prevention programme that includes policies and procedures reasonably designed to identify relevant red flags for the covered accounts and incorporate them into an identity theft prevention programme.

3.3 Managers: Tax Regime

US Manager
Fund management companies operating in the United States are generally formed as limited partnerships due to US self-employment tax considerations for the holders of interests in such entities that may make the use of a limited partnership more attractive than using an LLC. As a "flow-through" entity from a US federal income tax perspective, such a management company is generally not subject to tax at the entity level.

US managers often utilise a separate entity to receive any performance allocation or carried interest in its capacity as a GP, which offers several benefits, including flexibility among participants in the economics of each entity. Subject to special carried interest rules, amounts allocated to the GP as carried interest generally retain the character that they would have at the level of the relevant fund (ordinary income, short-term capital gain or long-term capital gain).

Non-US Manager
A non-US manager could become subject to US federal income tax if it is doing business in the United States. The determination is based on the applicable facts and circumstances. A management company located outside the United States for which non-US persons perform investment management services from such non-US location would not expect to be subject to US federal income tax (assuming it has no other business activity in the United States). Hiring US employees or leasing office space in the United States would generally be expected to cause a non-US manager to be considered as doing business in the United States. State and local tax

consequences (which may vary depending on the tax laws of the applicable state) also need to be considered. A non-US fund manager expecting to have a physical presence in the United States may be advised to form a US subsidiary treated as a corporation for US federal income tax purposes or other separate US entity that has an arm's-length contractual relationship with the non-US fund manager.

3.4 Rules Concerning Permanent Establishments

The activities of a US manager may be attributed to a non-US fund for US federal income tax purposes and cause such a fund to have a "permanent establishment" in the United States, unless the manager qualifies as an independent agent. However, if the activities of a fund consist of investing or trading in securities or commodities for the fund's own account (and do not involve loan origination, acting as a "dealer" in securities or commodities, or similar activities), then the presence of a US manager is generally not expected to cause a non-US fund to be subject to US federal income tax on the income and gain generated by the activity. Similar permanent establishment considerations may apply in non-US jurisdictions with respect to the activities of non-US managers.

3.5 Taxation of Carried Interest

A performance allocation, also known as a carried interest, made to a GP or managing member with an interest in the relevant fund is not currently treated as traditional compensation in the same manner as a fee for services. The character of the allocation of profit as ordinary income, short-term capital gain or long-term capital gain is preserved, provided that, with respect to applicable partnership interests held in connection with the performance of services, capital gain recognised by a partnership on the disposition of an asset that is held for not more than three years is treated as short-term capital gain when allocated to a non-corporate GP or managing member of certain alternative funds. Short-term capital gains are taxed at the same rates as ordinary income.

3.6 Outsourcing of Investment Functions/Business Operations

Alternative fund managers may outsource a substantial portion of their investment functions or business operations.

Use of Service Providers

Certain managers may have a much smaller number of middle- and back-office staff and may choose to rely on an external network of service providers for certain middle- and back-office functions. An external network can provide a manager with many advantages, such as the ability to choose between, and have access to, an array of "expert" service providers. For example, many alternative fund managers retain placement agents to assist in the marketing of funds they advise as well as independent administrators to provide accounting and back-office services (such as investor due diligence).

Managers remain responsible for the oversight of any outsourced investment functions or business operations, as well as ensuring that the firms carrying out such functions or operations are competent and, where applicable, licensed or registered with the appropriate agencies.

For example, placement agents marketing in or from the United States are governed by federal securities laws and the laws of the states in which a placement agent solicits investors. Placement agents are considered "brokers" as such term is defined under Section 3(a)(4)(A) of the Exchange Act. As a broker, placement

agents must register with the SEC before selling unregistered securities, including securities that are exempt from registration under Regulation D of the Securities Act. Placement agents must comply with the general solicitation, advertising and supervisory rules of FINRA and the SEC.

Assignment of Investment Management Functions

It is important to note that, while a manager may outsource many of their functions or business operations, Section 205(a)(2) of the Advisers Act prohibits the assignment of a client's advisory contract to another adviser without the client's consent. "Assignment" is broadly defined by Section 202(a)(1) of the Advisers Act, and includes any direct or indirect transfer of an advisory contract, as well as any transfer of a controlling block of the adviser's outstanding voting stock by a security holder of the adviser. However, Rule 202(a)(1)-1 provides that transactions that do not result in an actual change of control or management of the manager, such as some business reorganisations, are not "assignments" under the Advisers Act. The determination of whether an actual change of control has resulted from a transaction is an inherently factual determination, and the SEC does not generally respond to no-action letters on this question.

3.7 Local Substance Requirements

See **2.8 Other Local Requirements**. Registered investment advisers, CPOs and CTAs managing alternative funds are not subject to any regulatory capital requirements or other local substance requirements under applicable federal law and related SEC, CFTC and/or NFA rules.

3.8 Local Regulatory Requirements for Non-local Managers

There are no specific local regulatory requirements for non-local managers. See **3.2 Managers: Regulatory Regime**.

4. Investors

4.1 Types of Investors in Alternative Funds

Typically, US investors consist of high net worth individuals, family offices, funds of funds, registered investment companies, corporations, partnerships, trusts, insurance companies, other types of entity investors, foundations, endowments, charitable institutions, and benefit plan and retirement plan investors. There is also significant interest from investors in other jurisdictions. Over the past couple of years, there have been increased investments by sovereign wealth funds. For example, with respect to hedge funds, while endowment plans and foundations have decreased their allocation (on a relative basis), sovereign wealth funds are allocating to hedge funds more than ever (and are also the most willing of the major investor types to leave their funds locked up and have the lowest return expectations).

4.2 Marketing of Alternative Funds

See **2.3 Funds: Regulatory Regime** and **3.2 Managers: Regulatory Regime** for descriptions of the applicable investor qualification standards under the Securities Act, the Exchange Act, the Investment Company Act and the Advisers Act.

4.3 Rules Concerning Marketing of Alternative Funds

As discussed in **2.3 Funds: Regulatory Regime**, alternative funds typically offer their interests via exempt securities offerings under Rule 506 of

the Securities Act. Alternative funds relying on an exemption under Rule 506(b) are prohibited from engaging in any form of general solicitation or general advertising. Regulation D defines advertising to include:

- any advertisement, article, notice or other communication published in any newspaper, magazine or similar media, or broadcast over television or radio; and
- any seminar or meeting whose attendees have been invited by any general solicitation or general advertising.

Alternative funds relying on the exemption provided by Rule 506(c) may engage in general soliciting or general advertising. See **2.3 Funds: Regulatory Regime** for additional detail.

In order to rely on the safe harbour provisions provided by Rules 506(b) and 506(c), an offering cannot involve the participation of certain "bad actors" specified under the Rules. In particular, certain covered persons under Rule 506 – including the alternative fund, the fund's manager, its directors and executive officers, beneficial owners of 20% or more of the fund's voting interests, and other promoters, placement agents or solicitors acting on behalf of the fund – cannot be subject to a number of disqualifying events, such as criminal convictions, court injunctions and certain regulatory or disciplinary orders.

Many alternative funds use third-party placement agents or "finders" to solicit potential investors. These parties are generally required to be appropriately registered or qualified as broker-dealers at the federal and/or state level. Fund managers should be wary of engaging unregistered parties as "finders", as the finders' services may involve solicitation and marketing activities that require such persons to be registered broker-dealers. Sales of fund interests by unregistered persons may be subject to rescission rights under the Exchange Act. See **3.6 Outsourcing of Investment Functions/Business Operations**.

In December 2020, the SEC adopted amendments to Advisers Act Rule 206(4)-1 (the "Amended Marketing Rule"), which is the primary federal regulation governing the marketing communications of advisers, including managers of alternative funds.

The amendments affect many aspects of alternative fund marketing. Under the Amended Marketing Rule, the definition of "advertisement" now specifically addresses communications with prospective or existing private fund investors. An "advertisement" also includes any endorsement or testimonial for which a manager provides compensation, directly or indirectly. This applies to a compensated testimonial or endorsement made orally or in writing to one or more persons, and is designed to capture activity covered by the Cash Solicitation Rule, which has been rescinded. Under the Amended Marketing Rule, an "endorsement" now includes a placement agent's referral of an investor to a private fund. This is a substantial change for advisers in comparison to the Cash Solicitation Rule, which only covered separately managed account referrals and not private fund placement agent arrangements. The Amended Marketing Rule also sets forth specific guidance with respect to the presentation of performance information in advertisements.

Managers must comply with the Amended Marketing Rule by 4 November 2022.

An alternative fund manager registered with the SEC that has government entities (such as pension funds) as investors in its funds or solicits

such entities to invest (through internal marketing personnel or external placement agents) must comply with SEC Rule 206(4)-5, the Pay to Play Rule. The Pay to Play Rule prohibits an investment adviser from receiving management fees for a two-year period after the adviser or certain of its personnel makes a political contribution to an official of a government entity that is in a position to influence the award of advisory business to the adviser.

The SEC's Pay to Play Rule does not pre-empt the pay-to-play requirements that have been adopted by numerous states and local governments; therefore, alternative fund managers also need to address compliance with potential limitations on certain types of political contributions that arise under such laws. For example, state law may require a fund manager's personnel to register as a "lobbyist" in that jurisdiction. Fund managers will need to carefully consider the SEC and the state/local restrictions to ensure that they are in full compliance.

Like registered investment advisers, CPOs and CTAs must comply with marketing rules promulgated by the NFA. In particular, the NFA requires that certain principals and associated persons of CPOs and CTAs undergo background checks and pass the Series 3 licence (administered by FINRA) if they are engaged in certain marketing activities for a CPO or CTA.

4.4 Local Investors

Qualified local investors can invest in alternative funds established in the United States.

4.5 Investors: Regulatory Regime

Managers must generally follow a certain regulatory approval process in the United States to offer alternative funds, as discussed in **2.6 Regulatory Approval Process**. Managers are also generally required to follow the marketing rules discussed in **4.3 Rules Concerning Marketing of Alternative Funds**.

4.6 Disclosure Requirements

The identity of investors is not required to be disclosed under US law. Certain US alternative funds are commonly formed as limited partnerships in the State of Delaware. Under Delaware law, each limited partner has the right to obtain information reasonably related to its interest as a limited partner, including the right to access the books and records of the fund. An alternative fund's governing documents typically contain provisions restricting the disclosure of certain fund and investor information to other investors. Disclosure requirements are typically mandated by US federal laws, the GLBA, anti-money laundering (AML) legislation, ERISA, and US taxing authority and/or other regulatory requirements.

US Federal Laws

Certain state pension plans and governmental investors are subject to the US Freedom of Information Act and therefore may be required to publicly disclose certain information regarding investors in response to requests made by third parties.

Federal laws such as the Corporate Transparency Act may also require the disclosure of investor information such as the investor's name, date of birth, current address and unique identification number.

Gramm-Leach-Bliley Act

The GLBA permits the disclosure of an investor's identity in certain circumstances, generally to persons related to the fund and its operations. The GLBA also requires that investors have the ability to opt out of an alternative fund's sharing of their non-public personal information with

unaffiliated third parties. California and New York have similar statutes governing the disclosure of investors' personal information. Alternative funds are also subject to privacy notice delivery requirements, which describe how they use investors' non-public personal information and investors' rights to opt out.

Federal, State and Local Taxing Authorities

Alternative funds may be required to disclose certain investor information as part of their federal, state and local tax filings. A US fund that is treated as a partnership files annual federal, state and local income tax returns that include identifying information as to the partners in the fund. A non-US manager must typically file tax returns in the United States if it is deemed to have earned US effectively connected income (ECI). Alternative funds may also be required to disclose identifying information as part of the fund's compliance with the Foreign Account Tax Compliance Act (FATCA).

Anti-money Laundering

During regulatory examinations, SEC staff routinely request information from alternative fund managers regarding AML compliance policies and procedures, which may include the identity of fund investors.

Regulatory Disclosures

In certain instances, the SEC or CFTC may require the disclosure of the identities of "beneficial owners" of investors in alternative funds. During regulatory examinations, the SEC Division of Examinations staff routinely request investor lists from managers specifying the investor's name, address, capital account balance and investment positions. Managers may also be required to disclose certain investor information if they are subject to a subpoena by the SEC or CFTC.

4.7 Investors: Tax Regime

Different US federal income tax rules and tax rates apply depending on the tax status of the investor, the source and type of income and gains generated, and the tax status of the fund.

Tax-Exempt US Investors

Tax-exempt US investors – such as charitable organisations, pension funds, private foundations and individual retirement accounts – are generally exempt from US federal income taxation except to the extent that they earn "unrelated business taxable income" as defined in the Code, which commonly arises for such investors when an alternative fund that is treated as a partnership for US tax purposes obtains financing to acquire its investments or invests in an operating business with trade or business activity that is also treated as a partnership (or other "flow-through" entity) for US federal income tax purposes.

Non-corporate Taxable US Investors

Although tax rates are subject to change, the current maximum ordinary income tax rate for individuals is 37% and, in general, the maximum individual income tax rate for "qualified dividends" and long-term capital gains is 20%. An individual may be entitled to deduct up to 20% of their "qualified business income" each year, although income from alternative funds is often not expected to constitute qualified business income. In addition, individuals, estates and trusts are subject to a Medicare tax of 3.8% on "net investment income". Various limitations apply to an investor's ability to deduct certain losses and expenses, including capital losses, state and local income taxes, investment interest expense, and other investment expenses. Certain limitations depend on whether a fund takes the position that it is an "investor" or a "trader" for US federal income tax purposes.

Corporate Taxable US Investors

A typical corporate US investor is subject to entity-level US federal income tax at a rate of 21%. Corporate investors are not subject to all of the same limitations on the deduction of losses and expenses as non-corporate investors. Capital losses of a corporate taxpayer may be offset only against capital gains, but unused capital losses may be carried back three years (subject to certain limitations) and carried forward five years.

Non-US Investors

A non-US investor that receives an allocation or distribution of certain types of US-source income from a fund that is treated as a partnership for US tax purposes is generally subject to US withholding taxes of 30% (subject to reduction under an applicable income tax treaty) on such gross income (typically, non-business income such as dividends, certain dividend-equivalent income and certain interest income). Foreign governments and sovereign wealth funds may claim an exemption under Section 892 of the Code from such US withholding tax.

Capital gain of a non-US investor is not generally subject to US withholding tax unless it is attributable to the disposition of a US real property interest, including the disposition of stock or securities (other than debt instruments with no equity component) of a US real property holding corporation.

Non-US investors are also subject to regular US federal income tax on any income and gains that are "effectively connected" with the conduct of a US trade or business. For example, loan origination by a fund may be treated as generating ECI. Effectively connected earnings from a fund that are allocated to a non-US corporate partner may also be subject to a "branch profits tax". US funds with non-US investors are subject to withholding and reporting obligations with respect to such investors.

4.8 Foreign Account Tax Compliance Act (FATCA)/Common Reporting Standard (CRS) Compliance Regime

Under FATCA, in order to avoid a US withholding tax of 30% on its share of certain payments made with respect to certain actual and deemed US investments, a non-US investor will generally be required to provide identifying information with respect to certain of its direct and indirect US owners, or if it is a "foreign financial institution" within the meaning of Section 1471(d)(4) of the Code, such non-US investor will generally be required to register with the Internal Revenue Service in a timely manner and identify and report information with respect to certain direct and indirect US account holders (including debt holders and equity holders).

Non-US funds also have reporting and registration obligations under FATCA. Different and/or additional rules may apply to foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing FATCA or that are subject to the Organisation for Economic Co-operation and Development's Standard for Automatic Exchange of Financial Account Information in Tax Matters (the CRS). The United States is not a party to the CRS.

Schulte Roth & Zabel (SRZ) is widely regarded as the preeminent firm for hedge, private equity, credit and regulated funds. With more than 80 lawyers focused exclusively on representing investment funds and their managers, we expertly guide our clients through the creation and structuring of investment funds across every conceivable strategy. We focus as much on setting up the managing entity as we do on the fund itself, assuring its successful operation over the long term, and our vast knowledge about regulatory and compliance issues means that we provide our clients with the most incisive advice as they operate the fund.

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Trends and Developments

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The US Private Funds Industry in 2022

The following provides an overview of recent developments in the US concerning alternative investment funds and their investment programmes.

A rougher ride for risk assets

As the COVID-19 pandemic roiled global markets in 2020, US-based alternative investment fund managers took advantage of the resulting dislocations and generally delivered strong risk-adjusted performance to investors – all while navigating a fundraising environment that is more challenging, especially for nascent or smaller firms.

In 2021, managers coped similarly well with the "meme-stock" volatility in public markets, ongoing pandemic-related supply issues and inflation concerns in order to post impressive returns. In the hedge fund space, data aggregator Preqin reported positive inflows in every quarter of 2021 and positive performance for all major strategies that year. Meanwhile, managers of private equity and other closed-end funds pressed their advantage of recent years, attracting an increasing share of capital allocations. Several large firms reported record fundraising hauls.

Certainly, by comparison, the first two quarters of 2022 were a rougher ride for funds investing in risk assets. Ongoing inflation fears and the Russian invasion of Ukraine, among other factors, led to significant sell-offs across global markets, particularly in overheated US sectors such as technology, media and telecommunications and healthcare/biotech.

In these circumstances, and although green shoots have recently appeared, many US-based hedge fund managers may view flat-to-slightly positive returns for 2022 as a relative success. However, certain strategies – among them global macro, managed futures and relative value - have performed better than others and, as a whole, hedge funds are demonstrating again that they can be a safer haven in volatile times.

Managers of private debt and credit funds, distressed funds and certain "niche" or single-strategy funds (eg, energy and digital assets funds) are also doing well. They have managed to attract a meaningful share of new allocations – notwithstanding, in the case of digital assets funds, a significant 2022 drawdown in the asset class.

Private equity fund managers are facing a number of headwinds, including reduced deal flow, increased borrowing costs, more limited exit opportunities and valuation pressures. These same concerns appear to be somewhat dampening the investor appetite for venture capital funds. However, the sticky nature of closed-end fund capital, along with the huge store of dry powder remaining in private equity and venture funds, positions the managers of these products well to handle these issues.

Despite rising interest rates, which have made real estate and infrastructure fund investors more cautious, investors continue to be interested in funds that focus on non-traditional sectors of these markets, such as data centres, single-family rentals and warehouse/cold storage. All of

these market sectors have been resilient during the COVID-19 crisis relative to traditional core sectors such as office and hospitality. Additionally, several large private business development company (BDC) launches in 2022 evidence increasing interest in private BDCs.

Larger asset managers continue to dominate

In challenging times, investors return to familiar names, and thus the past decade's trend towards the largest asset managers increasing their market share has continued in 2022. It is expected to extend through at least the remainder of the year. According to Preqin, allocations to hedge funds are fewer in number in 2022, but markedly larger than in previous years. Global multi-strategy funds are currently topping investor preferences.

There is still support from larger institutional allocators for emerging managers, and a few new billion-dollar launches are in the works for 2022. However, one leading asset manager recently put this in perspective by estimating that there were at least 15 established managers seeking to raise USD15 billion or more in 2022 for new fund products.

A robust environment for secondaries

The volatility and valuation pressures of 2022 have created a robust environment for investor-led secondary transactions, as investors that are bound to lock-up periods or gates in their public markets investments look at secondary sales as a means of rebalancing positions to stay within target allocation ranges. General partner-led secondaries have also maintained a healthy pace this year, with term extensions and/or the formation of so-called "continuation vehicles" being relatively common for closed-end fund managers reluctant to sell assets at depressed valuations.

Scrutiny on fund expenses

Fee rates for alternative investment funds have generally remained stable (albeit strategy-dependent) for the past several years. Headline management fees are still at around 1.5-1.75% and performance fees are still in the range of 15%-20% - in the closed-end space, rates are often more than a preferred return in the range of 6-8%.

However, with funds growing in size and most managers now including expansive and granular fund expense terms, investors remain laser-focused on the related question of what expenses the management fee is and is not covering. Expenses related to third-party deal sourcers, travel, affiliated service providers, operating partners and certain regulatory and compliance items are often included by US managers as permissible fund expenses, for example; therefore, investor diligence and side letter requests are replete with items seeking limitations upon – or transparency relating to – such expenses. Organisational and offering expenses, which are invariably borne by investors, have also continued to climb higher. Hence investors often carefully review which sub-categories of such expenses are included and request an appropriate cap.

Thus far, the authors' experience is that few managers have successfully avoided side letters with investors. However, more managers now endeavour to minimise their side letter burden by addressing the most common requests directly in their fund documents.

ESG maintains momentum

The role of ESG considerations in managers' analyses has continued to attract the attention of state and federal administrations and US-based managers, investors and regulators in 2022.

Many investment managers use information about ESG factors in their analysis of investment opportunities. Investors increasingly view these factors as contributing towards private equity investment performance, according to the findings of a recent survey of more than 100 institutional investors conducted by the Institutional Limited Partners Association (ILPA) and Bain & Company.

Given the longer time horizons traditionally associated with the correlation between ESG factors and investment performance, the hedge fund industry has lagged behind private equity and other asset classes in its use of ESG considerations. However, rising investor interest in ESG (led by European investors but now also in the US) has spurred hedge fund managers to integrate ESG metrics into their investment processes through various methods, including screening, risk management, thematic investing and alpha-oriented approaches.

Investor interest in ESG is extending to the operations of fund managers, and managers are focusing on the ESG attributes of their firms in response to this interest. Investor diligence now commonly requires managers to describe their practices around the recruitment and retention of diverse talent, for example, and to provide demographic data. Forward-thinking managers targeting institutional capital would do well to consider these developments as they manage their operations and build their businesses.

That said, the consideration of ESG factors faces headwinds from certain market, political and regulatory forces. The 2022 correction in technology stock prices and rush to energy stocks in the US has put the returns of certain ESG impact funds under pressure.

ESG-focused investing has also become increasingly politicised in the US. The Department of Labor issued proposed rules in October 2021 supporting the consideration of climate risk by plan fiduciaries when financially material. Similarly, numerous state pension plans, university endowments and others have committed to divesting fossil fuel investments.

However, some US states are seeking to use the market power of their public pensions to lead an ESG backlash. In August 2022, the state of Florida approved a resolution to bar the state's USD186 billion pension fund from considering non-pecuniary factors when making investment decisions. Similar anti-ESG bills – some aimed at protecting the fossil fuel and firearms industries – have been enacted in several other US states, including Texas, West Virginia, North Dakota, Oklahoma and Kentucky

Increasing regulation is also on the horizon. With regard to regulatory developments, in May 2022 the Securities and Exchange Commission (SEC) proposed rules that will require managers to:

- provide extensive disclosures concerning their consideration of ESG criteria in publicly filed disclosure documents; and
- maintain operational policies and practices consistent with those disclosures.

An active regulatory landscape

Throughout 2022, SEC chair Gary Gensler has been implementing an ambitious agenda, which includes rulemaking and increased enforcement and examination activity that focuses heavily on private funds. In February, the SEC proposed a series of new rules and amendments to existing rules for private funds, which is perhaps of most significance to private fund advisers. If adopted, these changes will considerably impact existing

and future relationships between private fund advisers and investors by, among other things, prohibiting certain practices that traditionally have been addressed through disclosure and informed consent.

Additionally, numerous proposed rules aimed at private funds could substantially expand reporting and disclosure obligations, including with regard to quarterly performance, ESG, Form PF, short positions, swaps and beneficial ownership.

Other proposed rules target cybersecurity resiliency, special purpose acquisition companies (SPACs) and common hedge fund trading strategies (eg, day trading and arbitrage strategies).

On the examination front, the Division of Examinations has made private funds its top priority in 2022, paying particular attention to fees and expenses, compliance with fiduciary duties, custody rule compliance, conflicts, valuation, and risks and controls concerning material nonpublic information. Further attention has been focused on emerging areas such as ESG disclosures, digital assets, and the use of developing financial technologies such as alternative data research products.

Lastly, compliance with the new marketing rule, which was adopted in late 2020 with a compliance date of 4 November 2022, is expected to be an area of focus in late 2022 and into 2023.

Trends in special purpose acquisition companies

2021 saw significant interest both among institutional and hedge fund investors in new SPAC investments. As the number of new SPAC IPOs remained elevated, this interest increasingly focused on front-end sponsor-side investments for new SPAC launches, as well as on back-end investments related to de-SPAC transactions (eg, PIPEs and similar private investment structures).

In the first half of 2022, however, SPAC IPO activity fell dramatically, with only three SPAC IPOs raising in excess of USD500 million. That drop coincided with an increased regulatory focus on SPACs from the SEC, including proposed rulemaking efforts that could potentially reshape the liability landscape for future de-SPAC transactions. As a result, although investors are still interested in SPACs, their interest now focuses more on transactions supporting de-SPAC transactions, including through complex forward purchase agreement structures and similar longer-term private investments.

Going forward, the regulatory environment for SPACs seems likely to further curtail near-term IPO activity, particularly until the SEC provides greater certainty regarding any final rules. However, with the number of SPACs still seeking business combinations relatively high, opportunities remain for sophisticated institutional investors to participate in prospective de-SPAC transactions.

Conclusion

2022 is proving to be another fascinating and rewarding year for the private funds industry in the US. As the private capital markets continue to grow, managers and investors likewise grow in sophistication and creativity.

Schulte Roth & Zabel (SRZ) is widely regarded as the preeminent firm for hedge, private equity, credit and regulated funds. With more than 80 lawyers focused exclusively on representing investment funds and their managers, we expertly guide our clients through the creation and structuring of investment funds across every conceivable strategy. We focus as much on setting up the managing entity as we do on the fund itself, assuring its successful operation over the long term, and our vast knowledge about regulatory and compliance issues means that we provide our clients with the most incisive advice as they operate the fund.

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