Designing and Launching 1940 Act Regulated Funds: A Practical Guide

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Hedge Funds
Regulated Funds

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Pamela focuses on the representation of investment companies, business development companies, investment advisers and investment banking institutions in connection with the structuring, formation, funding and operation of investment products and services, including mutual funds, closed-end investment companies and registered hedge funds. She also advises clients on a broad range of regulatory and compliance matters associated with investment companies, investment advisory, brokerage, securities custody and transfer agent services.

A member of the Women's Investment Management Forum, Pamela is a contributor to *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press) and co-author of "SEC Proposes Rule Governing the Use of Derivatives and Short Sales by Registered Investment Companies and Business Development Companies," published by *Westlaw Journal — Derivatives*. She recently addressed what alternative investment managers need to know about managing 1940 Act funds and the new 1940 Act Rule 22e-4 at SRZ webinars.

Pamela earned her J.D. from Georgetown University Law Center and her B.A., *magna cum laude*, from Case Western Reserve University.

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Practices

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Kenneth S. Gerstein

Ken represents investment advisers, broker-dealers and banks in connection with the organization and operation of investment funds, including mutual funds, hedge funds, closed-end investment companies, business development companies and bank collective investment funds, and in connection with the development of other types of investment-related products and services. He has worked with clients in developing novel hybrid fund products, including registered hedge funds, registered funds of hedge funds and liquid alternatives products. Ken also advises clients on a broad range of securities regulatory and compliance matters, and represents mutual fund independent directors.

Prior to entering private practice, Ken served as special counsel in the SEC's Division of Investment Management in Washington, D.C. He is a member of the American Bar Association's Committee on the Federal Regulation of Securities and its Subcommittee on Investment Companies and Investment Advisers, and has been a member of the New York City Bar Association's Committee on Investment Management Regulation. A frequent speaker and author on issues related to investment funds and investment advisers, Ken is a co-author of *Hedge Funds: Formation, Operation and Regulation* (ALM Law Journal Press), and he has addressed issues for hedge fund managers acting as advisers and sub-advisers to registered funds and has spoken at industry conferences on various matters, including registered alternative investment funds.

After receiving his B.S. from the Wharton School of the University of Pennsylvania, Ken went on to obtain a J.D. from the James E. Beasley School of Law at Temple University, where he was a member of the Law Quarterly, and an LL.M. from Georgetown University Law Center.

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Practices

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John J. Mahon

John represents private equity firms and other financial sector participants in a wide range of capital markets and securities law matters. He regularly assists clients in connection with the establishment and operation of business development companies, registered closed-end funds and other similar public and private vehicles that comply with complex regulatory structures, including the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Dodd-Frank Act. With more than a decade of experience, John has been involved with more than 100 debt and equity offerings, including over 20 IPOs, reflecting an aggregate of over $10 billion in total proceeds. His work in securities law and mergers and acquisitions includes providing guidance to many New York Stock Exchange and Nasdaq-listed companies in connection with ongoing corporate governance and U.S. Securities and Exchange Commission reporting and compliance matters. John also routinely handles issues involving tender offers, proxy solicitations, going-private transactions and beneficial ownership reporting obligations.

John is a recipient of the SEC Capital Markets Award, and he was named a *Washington, DC Super Lawyers* “Rising Star.” He serves as an adjunct professor at The George Washington University Law School and is the former chair of the Corporate Finance Committee of the Corporation, Finance and Securities Law Section of the District of Columbia Bar. He has spoken and written on topics ranging from SEC regulations and disclosure obligations to public and private capital raising structures, 1940 Act regulated funds and M&A issues. Recently, John addressed what alternative investment managers need to know about managing 1940 Act regulated funds at an SRZ webinar.

John holds a J.D. from Georgetown University Law Center and a B.S.B.A., *cum laude*, from the University of Richmond, where he was a member of Beta Gamma Sigma.

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I. Benefits of 1940 Act Registration

A. Broader Flexibility in Offerings

1. Private investment funds relying on Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "1940 Act") for an exclusion from the 1940 Act definition of the term "investment company" are not required to register under the 1940 Act.

   (a) Section 3(c)(1) requires that a fund be sold in a private offering and limits the number of beneficial owners of interests in the fund to not more than 100 persons.

   (b) Section 3(c)(7) requires that a fund be sold in a private offering and that investors be limited to persons who are "qualified purchasers" as defined by Section 2(a)(51) of the 1940 Act (generally, individuals who own "investments" of $5 million or more and entities that own "investments" of $25 million or more).

   (c) The private offering requirements of Section 3(c)(1) and Section 3(c)(7) essentially require that offerings be made only to "accredited investors," as defined by Rule 501 of Regulation D under the Securities Act of 1933 (the "1933 Act") (generally, individuals having a net worth of more than $1 million or annual income in excess of $200,000).

2. Registration of a fund under the 1940 Act allows a fund to have more than 100 investors, without the need to sell interests in the fund only to qualified purchasers. This makes registered funds better suited to broad offerings by brokerage firms and financial advisory firms that have large numbers of clients, many of whom are not qualified purchasers. Also, the elimination of the 100-investor limit enables product sponsors to set lower minimum initial investment requirements without adversely affecting the amount of assets that can be raised.

3. Unlike a private investment fund, a registered fund can make a public offering by registering its shares under the 1933 Act. A publicly offered fund need not limit its investors to persons who are "accredited investors" and may use advertising and offer its securities to persons with whom it does not have a pre-existing substantive relationship.

4. Like registered funds, business development companies ("BDCs") are not subject to the various constraints applicable to private investment funds:

   (a) A BDC may sell its shares in a public offering.

   (b) There are no limitations that restrict the persons to whom shares of a BDC may be sold.

   (c) BDCs do not register under the 1940 Act. However, they are regulated in substantially the same way as registered funds, with certain exceptions.

5. Registered funds and BDCs (collectively, "regulated funds") may seek to qualify as regulated investment companies ("RICs") under Subchapter M of the Internal Revenue Code of 1986 (the "Code"). This enables them generally to avoid entity-level taxation and to provide simplified tax reporting to investors on Form 1099.

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6. Attachment A (Comparison of U.S. Alternative Fund Structures) compares the structure and features of private investment funds to those of registered funds and BDCs.

B. Other Benefits of 1940 Act Registration

1. Generally, a private fund's assets will be deemed "plan assets" for purposes of the Employee Retirement Income Security Act of 1974 ("ERISA") if 25 percent or more of the value of interests in the fund are owned by ERISA plans. Section 401(b)(1) of ERISA, however, explicitly provides that the assets of a fund registered under the 1940 Act are not plan assets. Thus, regardless of the extent of ownership of a registered fund by employee benefit plans, the fund's assets will not be plan assets and ERISA constraints will not apply to the management and investment of those assets.

2. The adviser of a fund (whether a private fund or registered fund) that makes use of commodity futures and other commodity interests may be eligible for an exemption from registration as a commodity pool operator ("CPO") and registration as a commodity trading advisor if the fund trades a de minimis level of commodity interests. However, advisers of registered funds have a somewhat greater ability than private fund managers to avail themselves of exemptions from registration and avoid various regulatory requirements imposed by the Commodity Futures Trading Commission.

   (a) Rule 4.13(a)(3) under the Commodity Exchange Act of 1974 (the "CEA") provides an exemption from registration as a CPO to the manager of a private investment fund if the fund's use of commodity interests is limited so as to meet one of two de minimis tests, and the fund is not marketed as a commodity pool or as a vehicle for trading in commodities.

   (b) The adviser of a registered fund may also avail itself of an exemption from CPO registration (pursuant to Rule 4.5 under the CEA) if similar requirements are met. However, in determining whether a registered fund's use of commodity interests satisfies the de minimis tests, commodity interests used for "bona fide hedging" purposes need not be considered.

3. Financial Industry Regulatory Authority ("FINRA") Rule 5130 ("Restrictions on the Purchase and Sale of Initial Equity Public Offerings") prohibits broker-dealers from allocating to specified "restricted persons" shares being sold in public offerings of "new issues" of equity securities that trade at a premium in the secondary market. As a practical matter, the rule requires that private funds create a "carve out" so that profits from new issues are allocated only to persons who are not restricted. The prohibitions of Rule 5130 do not apply to sales of new issues to registered funds.

II. Types of 1940 Act Registered Alternative Funds

A. Types of Funds

1. Registered funds are being used to deliver various types of alternative investment programs. Types of registered alternative funds include, among others: single manager/strategy funds (e.g., long/short, market-neutral, hedged-equity); multi-manager alternative funds; private equity funds; funds of hedge funds and funds of private equity funds; and real asset/commodities funds.

2. Generally, registered alternative funds are organized either as closed-end funds or open-end funds, including open-end funds that operate as exchange-traded funds ("ETFs"). The choice between these two structures is typically driven by the nature of a fund's investment program, the nature of its portfolio and consideration of other factors, including the fund characteristics/features desired by the fund's adviser and prospective distribution partners.

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(a) Open-end funds, by definition, are registered management investment companies that issue redeemable securities (i.e., shares that are redeemable at the option of the investor).

(b) A closed-end fund is a registered management investment company that does not issue redeemable securities.

(c) The provisions of Rule 22c-1 under the 1940 Act require that shares of open-end funds be redeemable on a daily basis. A closed-end fund is not subject to this requirement and thus has greater control over the timing of cash flows to/from the fund. A closed-end structure is required for funds that make significant investments in illiquid securities, but may also be desirable for alternative investment strategies where dealing with daily cash flows might adversely affect investment performance or where the fund's adviser wants to provide limited liquidity similar to the liquidity that is made available to investors in its private funds.

(d) Because shares of open-end funds are redeemable and such funds are generally required by Section 22(e) of the 1940 Act to pay redemption proceeds within seven days, the Securities and Exchange Commission (the "SEC") has taken the position that an open-end fund may not purchase an illiquid security if, as a result of such purchase, more than 15 percent of the fund's net assets would be invested in illiquid securities. This position, with some modification, has now been codified by Rule 22e-4, which was recently adopted by the SEC. *See* IV.H. below. Thus, registered alternative funds that invest a significant portion of their assets in securities that are illiquid (e.g., registered funds of hedge funds, registered private equity funds and certain distressed funds) may need to be structured as closed-end funds.

(e) The requirements of Rule 22e-4 may further limit the types of investment programs available to open-end funds.

(f) Although closed-end funds issue interests that are not redeemable, investors in a closed-end fund can be provided with liquidity similar to the liquidity of an investment in a hedge fund by means of repurchase offers made by the fund, or can be provided with liquidity similar to the liquidity of an investment in a private equity fund (by making distributions to investors only as the fund's investments are sold or become liquid).

(g) Alternatively, shares of a registered closed-end fund can be listed for trading on a securities exchange, which provides daily liquidity to investors without impacting fund cash flows.

B. Non-publicly Traded Closed-end Funds

1. A registered closed-end fund that is not traded on an exchange can be structured to have features similar to a private investment fund. Such a fund can be privately offered, impose a performance fee or incentive allocation, be taxed as a partnership and provide periodic liquidity to investors through repurchase offers. A privately offered fund needs to comply with Regulation D under the 1933 Act and to limit its investors to "accredited investors." In order to pay performance-based compensation, the fund would need to limit its investors to "qualified clients." *See* II.F below.

2. Non-publicly traded closed-end funds may provide liquidity to investors by making offers to repurchase interests. Repurchase offers may be made in reliance on Rule 13e-4 (the issuer repurchase rule) under the Securities Exchange Act of 1934 Act (the "1934 Act") or in reliance on Rule 23c-3 under the 1940 Act (the "interval fund" rule). In both cases, interests in a fund generally are repurchased based on the net asset value of the interests, determined as of a specified valuation date.

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(a) Funds that do not rely on Rule 23c-3 cannot commit to make repurchase offers in specified amounts or at specified periodic intervals. However, such a fund may establish a program under which it makes repurchase offers on a periodic basis (e.g., quarterly), subject to the approval of each such offer by the fund's board.

(b) A fund that relies on Rule 23c-3 is required to make offers to repurchase at a specified interval (either quarterly, semiannually or annually) and in each offer must offer to purchase a specified amount of interests equal to at least 5 percent, but not more than 25 percent, of outstanding interests. Various other conditions are imposed by Rule 23c-3.

(c) The conditions of Rule 23c-3 governing the timing and pricing of repurchase offers make it difficult for registered funds of hedge funds to rely on the rule. Such funds typically make repurchase offers in reliance on Rule 13e-4 under the 1934 Act.

(d) A registered fund that elects to be taxed as a partnership must limit the frequency of its repurchase offers (and restrict transfers of interests) to avoid becoming a publicly traded partnership taxable as a corporation. Interests in such a fund must not be redeemable or readily tradable. Semiannual offers, and quarterly offers with a notice requirement of 65 days, are typically viewed as acceptable in this regard.

3. The nature of prospective investors and the intended distribution channel generally play an important role in product design. For example, a large brokerage firm with retail distribution will generally prefer a more "investor friendly" product design, such as a publicly offered fund (which avoids the need to comply with rules applicable to private placements) that relies on Rule 23c-3 to make quarterly repurchase offers, does not pay performance-based compensation and is taxed as a "regulated investment company" under Subchapter M of the Code.

4. Public offerings by nontraded closed-end funds (as well as public offerings by other types of closed-end funds and open-end funds) are subject only to notice filings under state "blue sky" laws.

C. Publicly Traded Closed-end Funds

1. From an adviser's perspective, a publicly traded closed-end fund is a "permanent capital" vehicle (i.e., assets of the fund are not subject to decrease as a result of redemptions of shares or withdrawals of capital).

2. Publicly traded closed-end funds are often used by asset managers in lieu of a BDC structure (which is further described in III.E. below) because such funds can invest in non-U.S. companies and make other investments that would be considered "bad" assets for a BDC.

3. As a practical matter, the adviser of a publicly traded registered fund cannot receive performance-based compensation. *See* II.F. below. However, unlike 1940 Act registered funds, BDCs (including publicly traded BDCs) may pay performance-based fees, without having to restrict their investors to qualified clients. *See* II.E.1.(c) below. In addition, both registered funds and BDCs may pay fees computed as a percentage of their income.

D. Open-end Funds

1. In recent years, there has been a growing number of registered open-end investment companies (mutual funds) that pursue alternative investment strategies, including multi-manager alternative funds that are sub-advised by private fund advisers who are each responsible for managing a "sleeve" of a single fund investment portfolio.

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2. Rule 22c-1 under the 1940 Act requires that mutual funds determine the net asset value of their shares and honor requests for redemptions of shares on a daily basis. Under Section 22(e) of the 1940 Act, mutual funds must make payment of redemption proceeds within seven days absent certain specified extraordinary circumstances (such as when the New York Stock Exchange is closed other than for customary closings).

3. Generally, mutual funds are publicly offered on a continuous basis and investors can purchase shares on a daily basis. For this reason, mutual funds must periodically update their prospectuses by filing post-effective amendments to their registration statements with the SEC.

4. Generally, mutual funds need to qualify as RICs to avoid entity-level taxation (because the publicly traded partnership rules would preclude partnership taxation of a 1940 Act registered fund that provides daily liquidity).

5. Most ETFs are structured as open-end funds. Unlike a mutual fund, however, the shares of an ETF trade on a stock exchange at prices determined by the market.

   (a) Unique to an ETF is the process by which shares of an ETF are created. Large institutional investors and market makers have the ability to provide baskets of securities to an ETF in exchange for blocks of shares called "creation units," which shares can then be sold on an exchange. Similarly, shares of ETFs can be redeemed in creation units on an "in-kind" basis. It is this mechanism that, in large part, enables shares of an ETF to trade at prices that closely track the net asset value of the ETF's shares.

   (b) ETFs can be index-based or actively managed.

E. Business Development Companies

1. Characteristics of BDCs

   (a) A BDC is a closed-end investment management company that elects to be regulated under the BDC-related provisions of the 1940 Act in lieu of registering as an investment company under the 1940 Act. In many respects, a BDC is regulated under the 1940 Act in the same way as a registered closed-end fund. Subject to certain requirements discussed below, BDCs may invest in equity securities or debt securities. A BDC that invests primarily in loans and other types of debt securities is essentially a hybrid between a public finance company and a registered investment company from a regulatory perspective, and can access public capital markets.

   (b) Shares of a BDC may be offered publicly (in which case such shares may be listed for trading on a securities exchange) or may be offered in a private placement. Privately offered BDCs may only be sold to accredited investors. Private BDCs are often sponsored by private equity firms. In many cases, shares are offered through a private placement to the sponsor's existing investor base, rather than via a public offering. BDCs following this model typically draw down capital via capital calls, similar to a private equity fund. A private BDC will generally target a future initial public offering and exchange listing.

   (c) BDCs are permitted by Section 205 of the Advisers Act to pay performance-based fees based on capital gains similar to private funds without limiting their shareholders to qualified clients. However, any performance fee based on capital gains cannot exceed 20 percent of the BDC's realized capital gains, net of realized losses and unrealized capital depreciation. Like registered investment companies, BDCs may also pay asset-based advisory fees.

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(d) In exchange for greater regulatory flexibility, a BDC must invest 70 percent of its assets in "good" BDC assets. Generally, such "good" or eligible assets are securities of U.S.-organized, privately held (or "micro-cap" public) operating companies (non-3(c)(1) or -3(c)(7) entities). For these purposes, "micro-cap" companies are those with less than $250 million in public market capitalization.

(e) BDCs may issue debt securities as well as other senior securities. A BDC issuing debt or other senior securities must comply with an asset coverage requirement under which it is required to have at least a 200-percent asset coverage ratio (total assets to debt/senior securities). This asset coverage requirement is less stringent than the asset coverage requirement applicable to borrowings by registered funds. *See* IV.C. below.

(f) A BDC may issue convertible securities, including options, warrants and rights, subject to the receipt of shareholder approval to do so and provided that common stock underlying such convertible securities does not, in the aggregate, exceed 25 percent of the BDCs outstanding shares.

(g) BDCs file annual, quarterly and current reports under the 1934 Act on the same basis and in the same manner as traditional public operating companies.

(h) BDCs can elect to be taxed as RICs. The same qualification requirements under the Code that apply to registered funds apply to BDCs that seek to be taxed as RICs. If a BDC is taxed as a RIC, tax-exempt investors may invest directly in the BDC and need not invest in the BDC through an offshore blocker. *See* III.C below.

2. Benefits of BDC Status

(a) Unlike a private investment fund, a BDC is not required to limit the number of its investors or to sell its shares only to qualified purchasers. Also, because a BDC (unlike a private investment fund) can make a public offering, a BDC can use advertising in marketing its shares and sell its shares to investors who are not accredited investors.

(b) A BDC can charge a performance-based fee without limiting its investors to qualified clients. *See* II.E.1(c) above.

(c) If a BDC elects to be taxed as a RIC, it can avoid entity-level taxation and provide tax reporting to investors on Form 1099, which is generally preferred by investors.

(d) In certain respects, BDCs have greater flexibility under the provisions of the 1940 Act regulating transactions with affiliates.

3. BDC Management

(a) Some BDCs are internally managed by employees of the BDC. Under these circumstances, employees can be compensated by the BDC through salaries and pursuant to a "profit-sharing plan" that pays out annually no more than 20 percent of the BDC's net income.

(b) A BDC must "make available" to its investee companies "significant managerial assistance." This requirement will be met if the BDC offers to provide to an investee company (and, if accepted, does provide) significant guidance and counsel concerning the management, operations, or business objectives and policies of the investee company. The requirement can also be met if the BDC exercises a controlling influence over the management or policies of an investee company (or exercises such influence as part of a control group).

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(i) Investee companies typically do not accept offers from BDCs to provide managerial assistance.

(ii) A BDC may receive compensation for providing these services.

4. Other Regulatory Considerations

(a) BDCs must make regular public disclosures of their financial condition (financial statements, including a schedule showing each of their investments) on a quarterly basis (i.e., on Forms 10-Q and 10-K). Year-end financial statements of a BDC are required to be audited. Quarterly and annual financial statements are subject to Sarbanes-Oxley certifications. BDCs also have ongoing 8-K reporting obligations and must disclose certain material corporate events promptly on Form 8-K.

(b) A BDC may be restricted in its ability to co-invest with other funds and accounts managed by the investment adviser of the BDC. *See* IV.E below.

F. Performance-based Fees/Allocations

1. A registered fund that pays compensation to its investment adviser based on capital gains (other than a fulcrum fee) cannot be publicly traded because such compensation may be paid only if all investors in the fund are "qualified clients" and there presently are no mechanisms available to restrict ownership of the fund's shares to such investors.

2. However, a registered fund can have a fee structure that is similar to that of a private investment fund (e.g., an asset-based management fee and an incentive allocation or incentive fee based on the fund's net investment income, and realized and unrealized capital gains) if interests in the fund are not publicly traded and are sold only to "qualified clients."

(a) Rule 205-3 under the Investment Advisers Act of 1940 (the "Advisers Act") provides an exemption from the general Advisers Act prohibition on performance fees where a fund is sold only to persons who are "qualified clients" (generally, a person with a net worth of more than $2 million, excluding the value of their principal residence, or who has at least $1 million under the management of the fund's adviser and its affiliates).

(b) As a result of the provisions of Rule 205-3, interests in a registered fund of hedge funds that does not impose a performance-based fee (or allocation) must also be sold only to qualified clients if the registered fund invests in any domestic hedge fund that: (i) has a performance-based compensation arrangement; (ii) relies on Section 3(c)(1) of the 1940 Act; and (iii) is managed by a registered adviser. (This results from a "look through" to the investors in the registered fund that is required by Rule 205-3 when determining whether investors in an underlying fund relying on Section 3(c)(1) are qualified clients.)

3. Section 205(b)(2) of the Advisers Act permits the adviser of a registered fund to receive performance-based compensation that is determined based on the net asset value of the fund averaged over a specified period and increasing and decreasing proportionately based on the investment performance of the fund measured over a specified period relative to the investment performance of an appropriate securities index. Such fees (called "fulcrum fees") must be computed in accordance with Rule 205-1 and Rule 205-2 under the Advisers Act.

Fees based on a percentage of the net investment income of a fund are also permissible.

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III. Forming a Regulated Fund

A. Corporate Formation

1. Most registered funds and BDCs are organized as corporations, statutory trusts or business trusts. Privately offered closed-end funds and BDCs are sometimes organized as limited liability companies ("LLCs") or limited partnerships.

(a) Corporations remain attractive because of the protection from liability afforded to shareholders. The venues of choice for corporations are Delaware and Maryland. The corporate laws of these states include provisions that provide greater flexibility to registered funds than to ordinary corporations regarding certain matters.

(b) Statutory trusts and business trusts are unincorporated associations that are governed by boards of trustees. Like corporations, statutory trusts and business trusts protect shareholders from liability. Most registered funds that choose the trust form are organized in Delaware or Massachusetts.

(c) An LLC is a hybrid form of business entity that combines corporation-style limited liability with partnership-style flexibility. The owners of an LLC are "members," rather than shareholders or partners. Registered funds taxable as partnerships are frequently organized as LLCs.

B. Registration Under the 1940 Act and 1933 Act

1. Registration Statements

(a) Open-end funds and closed-end funds register under the 1940 Act by filing Form N-8A (a notification of registration).

(b) Open-end funds are required to file 1940 Act registration statements with the SEC on Form N-1A.

(c) Closed-end funds are required to file 1940 Act registration statements with the SEC on Form N-2.

(d) Forms N-1A and N-2 are also used to register shares of a fund under the 1933 Act to enable a public offering.

(e) A BDC must file a Form N-54A (a notification of its intent to be subject to Section 55 through 65 of the 1940 Act) and a registration statement on Form N-2.

(f) A public offering of a fund's shares cannot commence until its registration statement under the 1933 Act becomes effective. As a matter of practice, a 1933 Act registration statement does not become effective until it is declared effective by the SEC staff. If a fund's shares are privately offered, the fund can commence the offering of its shares once it registers with the SEC, but it is generally advisable not to commence the offering until comments from the SEC staff are received and appropriately addressed.

(g) Forms N-1A and N-2 require disclosures relating to a variety of matters, including but not limited to: (i) fund fees and expenses; (ii) investment practices and restrictions; (iii) risks; (iv) management and distribution arrangements; (v) brokerage policies; (vi) taxation; (vii) distribution arrangements and charges; and (viii) financial information. In the case of a publicly offered fund, this information appears either in the fund's prospectus (which is part of the

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registration statement) or in the fund's statement of additional information ("SAI") (which, like the prospectus, is part of the registration statement, but which need be provided to prospective investors only upon request).

(h) A publicly offered closed-end fund must also receive "no objections" clearance from FINRA regarding the reasonableness of the compensation to be received by brokers in connection with the offering, unless the fund is an interval fund that makes periodic repurchase offers pursuant to Rule 23c-3 under the 1940 Act or the fund obtains exemptive relief from FINRA, in which case the sales load limitations of FINRA Rule 2341 (formerly, NASD Conduct Rule 2830) will apply.

(i) A registered fund is required to have "seed capital" of $100,000 prior to commencing a public offering of its shares. (Section 14(a) of the 1940 Act.) The registration statement of a registered fund must include an audited balance sheet reflecting this seed capital.

(j) Open-end funds, as well as closed-end funds that continuously offer their shares, must update financial and other information contained in their registration statements on a periodic basis. Post-effective amendments on Forms N-1A and N-2 are filed annually for this purpose. It may be necessary to supplement a registered fund's prospectus or SAI at other times if there are material events or changes in a fund's features or policies that would, if not disclosed, cause existing disclosures to be misleading.

2. Registering a Definite/Indefinite Number of Securities

(a) Section 24(f) of the 1940 Act and Rule 24f-2 allow an open-end investment company to register an indefinite number of securities under the 1933 Act. If a fund registers an indefinite number of securities, annual filings must be made and the requisite fee paid no later than 90 days after the end of the fund's fiscal year. Registration fees are based on net sales (i.e., redeemed shares are used to offset shares sold for purposes of computing the fee). Interest begins to accrue on the amount of the fee due if the fee is not paid within the 90-day period.

(b) Closed-end funds and BDCs register a specified number of shares under the 1933 Act (generally, the number of shares expected to be sold in the offering to be made pursuant to the registration statement) and pay filing fees in connection with such registration. Only shares that have been registered may be sold, and once all shares registered under a registration statement have been sold, additional shares must be registered.

C. Tax Considerations

1. Taxation Options

(a) Most registered funds and BDCs seek to qualify as RICs under Subchapter M of the Code. This enables the funds to avoid entity-level taxation if certain required distributions are made to investors and also enables the funds to provide simplified tax reporting to investors on Form 1099.

(b) Registered closed-end funds can also opt to be taxed as partnerships, in which case tax reporting to investors is provided on Schedule K-1. If a registered fund is taxed as a partnership, it does not have to meet the requirements of the Code applicable to RICs.

(c) There is a strong preference in retail distribution channels for tax reporting on Form 1099. However, when it is anticipated that concentration of a fund's investment positions or the

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sources of its income will preclude RIC qualification, a registered closed-end fund taxable as a partnership may be the only viable option.

(d) Registered funds and BDCs that qualify as RICs are treated as corporations for tax purposes. Thus, there is no flow through to U.S. tax-exempt investors in such funds of unrelated business taxable income (UBTI).

(e) Funds taxed as partnerships are typically organized as limited liability companies or limited partnerships. Funds taxed under Subchapter M are typically organized as statutory trusts, business trusts or corporations.

2. RIC Qualification

(a) To qualify as a RIC, a registered fund or BDC must meet a quarterly diversification test as well as an annual test relating to the sources of its income.

(i) Under the diversification test, as of the end of each taxable quarter, at least 50 percent of a RIC's assets must be represented by: cash; U.S. government securities; securities of other RICs and other securities as to which the RIC's investment is limited in respect to any issuer to an amount not greater than five percent of the value of the RIC's total assets and not greater than 10 percent of the outstanding voting securities of such issuer. In addition, a RIC generally may not invest more than 25 percent of its assets in the securities (other than U.S. government securities and securities of other RICs) of any one issuer or in the securities of one or more qualified publicly traded partnerships.

(ii) Under the source of income test, at least 90 percent of a RIC's gross income during its taxable year must be derived from: dividends; interest; payments with respect to securities loans; gains from the sale or other disposition of stock; securities or foreign currency; certain other income (including, but not limited to, gains from options, futures and forward contracts) derived with respect to its business of investing in stock, securities or currencies; or from net income derived from an interest in a qualified publicly traded partnership. For purposes of this test, non-qualifying (or "bad") income would include income derived from: non-financial commodities; direct ownership of real estate and rents from real property; certain unincorporated entities; and intangibles, such as trademarks, patents and royalties.

(b) RICs sometimes use "blocker" entities taxable as corporations for U.S. tax purposes to hold investments that would generate bad income if held directly by a RIC in order to facilitate their investment programs.

D. Distribution Arrangements

Shares of registered fund shares may be sold with or without sales charges. Generally, sale charges may be front-end sales loads (paid by an investor at the time shares are purchased), deferred sales loads (paid by an investor in the event redeemed shares have not been held for a specified period) or asset-based sales loads (paid over time as an expense of the fund). (Typically, the amount of a deferred sales load declines each year over a specified period.)

1. Although Section 22(d) of the 1940 Act essentially requires that all investors pay the same sales charges, Rule 22d-1 under the 1940 Act permits open-end funds and their principal underwriters to implement discounts in (or elimination of) sales charges if applied on a uniform basis to all investors of a specified class and disclosed to existing shareholders and prospective investors. This permits the use of quantity discounts, rights of accumulation and other sales charge reductions and waivers.

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FINRA Rule 2341 limits the maximum sales charges that may be imposed by open-end funds and by "interval funds" relying on Rule 23c-3.

2. Many open-end funds issue multiple classes of their shares, each having varying fees and expenses based on differences in the distribution-related expenses and shareholder services of the classes, as permitted by Rule 18f-3 under the 1940 Act. The different share classes are used to address the needs and preferences of different investors and different distribution channels (e.g., investors who prefer a front-end load rather than a deferred sales load, or financial intermediaries that prefer a share class that does not incur any distribution-related expenses — for use by clients participating in advisory programs that pay asset-based fees — and a share class that incurs distribution-related expenses — for use with brokerage clients who pay commissions on their transactions).

3. Continuously offered closed-end funds sometimes issue multiple classes of shares for similar reasons. However, a closed-end fund must obtain an exemptive order from the SEC to do so (because Rule 18f-3 is available only to open-end funds).

4. Open-end funds are prohibited by Rule 12b-1 under the 1940 Act from financing any activity that is primarily related to the distribution of their shares to investors except in accordance with a plan of distribution adopted in accordance with the requirements of the rule. A fund's 12b-1 plan must be approved by the board of directors of the fund, and by vote of a majority of the directors who are not "interested persons" of the fund or its investment adviser ("Independent Directors"). In addition, if the plan is adopted after any public offering of the fund's shares or the sale of shares to any persons other than affiliates of the fund or its promoters, the 12b-1 plan must be approved by fund shareholders. Similar approvals are required to amend a plan to increase materially the amount to be spent for distribution. A 12b-1 plan may remain in effect from year to year if annually approved by the fund's board and by a vote of majority of the Independent Directors.

5. Closed-end funds are not subject to the prohibition of Rule 12b-1. However, closed-end funds that obtain orders to issue multiple share classes are required, as a condition of such orders, to comply with the provisions of Rule 12b-1.

6. In January 2016, the SEC staff issued an IM Guidance Update (No. 2016-01) setting forth its views on issues associated with an open-end fund making payments to financial intermediaries that provide shareholder and account-related services ("sub-accounting" services) with respect to their customers that hold shares of the fund. As noted by the SEC staff, financial intermediaries receiving these payments generally also provide distribution-related services to funds. For this reason, the staff expressed the concern that, in certain circumstances, fees paid by a fund for sub-accounting services may, at least in part, constitute payments for distribution-related services, which would be prohibited unless paid in accordance with a 12b-1 plan. The staff stated that it is the responsibility of the fund's board to determine whether sub-accounting fees (or any portion of such fees) are being used to pay for distribution.

7. Open-end funds and closed-end funds conducting continuous offerings of their shares may enter into selling or underwriting agreements directly with brokerage firms wishing to sell shares of the funds. However, for regulatory and operational reasons, these funds typically retain a distributor to serve as principal underwriter and, in such cases, the distributor enters into selling agreements with intermediaries. Closed-end funds and BDCs making public offerings typically enter into underwriting agreements with brokerage firms. Many fund administrators have affiliated broker-dealers that can serve as distributors and will provide basic distribution services to funds for which they act as administrator. In addition, there are independent marketing firms that can be retained to serve as distributors of a fund. Some of these firms are equipped to serve as "wholesalers" and provide

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access to gatekeepers at brokerage firms and distribution support services that brokerage firms may require.

E. Fund Administration and Compliance

1. Operating registered funds and BDCs requires implementation of policies and procedures to help assure compliance with the 1940 Act and other laws.

(a) Rule 38a-1 under the 1940 Act requires that registered funds and BDCs adopt policies and procedures reasonably designed to prevent violations of the federal securities laws. The rule also requires the appointment of a chief compliance officer ("CCO"). A fund's compliance program and its CCO must be approved by a fund's board and by vote of a majority of its Independent Directors. In addition, the CCO's compensation must be similarly approved.

(b) On an annual basis, the CCO must review the adequacy of the compliance program and provide a report to the fund board regarding that review.

(c) A fund's CCO may be removed only by action of the fund's board and by vote of a majority of the Independent Directors.

(d) There is no prohibition on the CCO of a fund also serving as CCO of the fund's adviser.

(e) There is no prohibition on a fund outsourcing the CCO function to a person employed by a firm that is not affiliated with the fund or its adviser. However, the SEC's Office of Compliance Inspections and Examinations ("OCIE") has cautioned that such arrangements should be reviewed to assure that the requirements of SEC rules relating to compliance are being satisfied. (*See* OCIE Risk Alert, "Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers," Nov. 9, 2015.)

2. Registered funds and BDCs require various administration, fund accounting and transfer agent services in connection with their operations. An outside administrator and transfer agent can be retained by a fund to supply these services. The services provided by an administrator can include the preparation of financial statements, handling regulatory filings and preparing and distributing materials relating to board meetings (including agendas and drafts of minutes). Services may also include supervision of regulatory and tax compliance.

F. Corporate Governance

1. Composition

Open-end funds, closed-end funds and BDCs are required to have boards of directors (or, in the case of funds organized as trusts, boards of trustees). A specified percentage of a fund's board must be comprised of Independent Directors. (Section 10(a) of the 1940 Act.)

(a) As a practical matter (because of the conditions of Rule 0-1 under the 1940 Act that apply to funds that rely on certain 1940 Act exemptive rules), Independent Directors must comprise a majority of a registered fund's board. Section 56 of the 1940 Act requires that a majority of the members of a BDC's board be Independent Directors.

(b) Generally, persons who are not affiliated with and do not have any direct or indirect beneficial interest in any securities of the fund's investment adviser or principal underwriter (or any of their controlling persons) will not be "interested persons" and will, therefore, qualify as Independent Directors. (Section 2(a)(19) of the 1940 Act.)

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2. Board Responsibilities

   (a) Advisory Agreements and Principal Underwriting Agreements: A regulated fund's investment advisory agreement and its agreement with any principal underwriter (i.e., the firm that serves as the distributor of the fund's shares) must be approved by the fund's board and by a majority of the fund's Independent Directors. (Section 15 of the 1940 Act.)

      (i) Advisory agreements and principal underwriting agreements may have initial terms of not more than two years from the dates of their execution and may continue in effect from year to year thereafter if such continuance is approved at least annually by a fund's board and by a majority of its Independent Directors. Advisory agreements must be terminable by the fund, without penalty, on not more than 60 days' notice.

      (ii) Advisory agreements and principal underwriting agreements must provide for their automatic termination in the event of an "assignment," including a deemed assignment resulting from a change in control of the adviser or principal underwriter.

      (iii) In approving and continuing an investment advisory agreement, directors of a fund have a duty to request and evaluate, and the adviser of the fund has a duty to provide, such information as may reasonably be necessary to evaluate the terms of the agreement. (Section 15(c) of the 1940 Act.)

      (iv) In addition, Section 36(b) of the 1940 Act provides that the investment adviser of a regulated fund has a fiduciary duty with respect to the receipt of compensation paid by the fund and its shareholders to the adviser (and its affiliates). This has been interpreted in judicial decisions as requiring that an advisory fee be comparable to that which would have been established through arms'-length negotiation.

      (v) The SEC has brought enforcement actions against investment advisers and fund directors where the informational requirements of Section 15(c) of the 1940 Act have not (in the view of the SEC) been met. In connection with such actions, the SEC has found that boards were furnished with incomplete information or failed to request sufficient information.[1]

   (b) Audit Committee: A regulated fund's board of directors must have an audit committee comprised of Independent Directors. The audit committee is required annually to approve the retention of the fund's independent accountants and to preapprove nonaudit services provided to the fund (and, in certain cases, nonaudit services provided to affiliates of the fund, including the adviser and its affiliates that are deemed part of the investment company complex).

   (c) Approval of Accountants: The selection of a fund's independent accountant must also be approved annually by a fund's board and by a majority of its Independent Directors within a specified time frame. (Section 31(a) of the 1940 Act and Rule 32a-3.)

3. Other Board Responsibilities: Fund boards and Independent Directors have a wide range of other responsibilities imposed by rules adopted under the 1940 Act and must approve various other matters relating to a fund's operations.

[1] *In the Matter of Kornitzer Capital Management, Inc. and Barry E. Koster*; *In the Matter of Commonwealth Capital Management, LLC, et al.*; *In the Matter of Northern Lights Compliance Services LLC, et al.*

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(a) The board of a fund has general oversight responsibilities with respect to the operations of the fund and the services provided to the fund by its investment adviser and other service providers.[2]

(b) Fund boards typically meet on a quarterly basis. Although participation in such meetings by telephone is generally permissible, Independent Directors must vote "in person" on the approval and continuance of advisory agreements, principal underwriting agreements and 12b-1 plans and on the selection of the fund's independent accountants.

(c) Independent Directors typically are paid annual retainers and per-meeting fees by the fund. In addition, those serving as committee chairs or board chair (or lead independent director) may be paid additional annual retainers.

(d) It is "best practice" that Independent Directors be represented by separate legal counsel. If a fund relies on various exemptive rules, Rule 0-1 under the 1940 Act requires that any such counsel be determined by the Independent Directors initially, and thereafter on an annual basis, to be "independent legal counsel" based on a determination that any representation by such counsel of the fund's investment adviser, principal underwriter or administrator (or any of their control persons) since the beginning of the fund's last two completed fiscal years has been sufficiently limited such that it is unlikely to adversely affect the professional judgment of such counsel in providing representation to the Independent Directors.

4. Shareholder Voting: The 1940 Act and its rules require shareholder voting with respect to certain matters. When a shareholder vote is required, a meeting of shareholders and the solicitation of proxies from shareholders to be voted at the meeting is generally necessary. The solicitation of proxies must be conducted in accordance with the requirements of proxy rules adopted by the SEC under the 1934 Act.

   (a) Investment advisory agreements (and material amendments to such agreements) must be approved by a fund's shareholders. (The fund's advisory agreement is typically approved at the time of the fund's formation by written consent of the fund's sole initial shareholder, prior to the sale of shares to investors. Thus, a shareholder vote is generally necessary only to amend an advisory agreement or to approve a new advisory agreement after the fund has commenced operations.) (Section 15(a) of the 1940 Act.)

   (b) Directors must be elected by shareholders under certain circumstances, including if: (i) appointment of a new director would result in less than two-thirds of the fund board having been elected by shareholders; or (ii) less than 50 percent of the persons serving as directors have been elected by shareholders. (The initial directors of a fund are generally approved by written consent of the fund's sole initial shareholder at the time of the fund's formation and prior to the sale of shares to investors.) (Section 16 of the 1940 Act.)

   (c) Certain investment policies of a registered fund may not be changed without a shareholder vote. This would include, among other things, a change in a fund's policy with respect to concentration of investments, a change in a fund's status from a diversified company to a nondiversified company, a change in policies relating to the borrowing of money or the issuance of senior securities, and any change in other investment policies that have been deemed fundamental by the fund. (Section 13 of the 1940 Act.)

[2] The responsibilities of regulated fund directors include, among other things: monitoring fund investment performance; reviewing fund disclosure documents (and signing registration statements of the fund filed with the SEC); approving agreements with service providers; approving the fund's fidelity bond; reviewing the fund's brokerage commissions and allocation practices; supervising administration of the fund's compliance program; approving valuation procedures; approving the times as of which fund shares are priced; and monitoring the quality and cost of services provided to the fund.

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(d) A shareholder vote is also needed to adopt a 12b-1 plan (if the fund has commenced operations prior to the plan's adoption) and to amend a 12b-1 plan to increase materially the amount to be spent on distribution. (Rule 12b-1 under the 1940 Act, discussed above.)

IV. Key Regulatory Considerations

A. Applicability of 1940 Act Investment Restrictions

1. Registered funds and BDCs are subject to various investment-related restrictions and limitations imposed by the 1940 Act. Among other things, these include restrictions on investments in the securities of securities-related issuers (Section 12(d)(3) of the 1940 Act) and limitations on the use of leverage (Section 18 of the 1940 Act) under which asset coverage requirements apply to the issuance of "senior securities". *See* IV.C below.

2. The use of registered funds is feasible for delivering alternative investment strategies to investors only where the investment programs fit within the 1940 Act regulatory scheme. However, most hedge fund investment programs, including those involving the use of leverage and short sales of securities, can be implemented consistent with requirements of the 1940 Act, except for certain highly leveraged strategies.

B. Prohibitions on Transactions with Affiliates

1. The 1940 Act and the rules thereunder contain various provisions (e.g., Section 17(a) and Rule 17d-1 for registered funds, and Section 57 for BDCs) that generally prohibit affiliated persons of a registered fund or BDC, and affiliated persons of such persons, from engaging in any principal transaction, or participating in any joint enterprise or other joint arrangement, with the registered fund or BDC.

2. The provisions of Rule 17d-1 (and Section 57(a)(4) with respect to BDCs) prohibiting joint enterprises need to be considered in connection with the purchase or sale of privately offered securities where both a regulated fund and any of its affiliated persons (including other funds) are purchasing or selling the same securities (or securities of the same issuer). *See* IV.B below.

3. Many BDCs have obtained SEC exemptive orders permitting co-investments with affiliated funds that would otherwise be prohibited pursuant to Section 57(a)(4). *See* IV.E below.

4. The prohibition of Section 17(a) on affiliated transactions must also be considered when managing a registered fund of hedge funds. Generally, a private fund in which a registered fund of hedge funds proposes to invest may be an affiliated person of the registered fund if: (i) the adviser of the registered fund of funds serves as or is affiliated with the general partner/adviser of the private fund; (ii) the registered fund of funds owns five percent or more of the outstanding voting securities of the private fund; or (iii) funds and other accounts managed by the adviser of the registered fund of funds own, in the aggregate, five percent or more of the outstanding voting securities of the private fund (Section 2(a)(3) of the 1940 Act). For this reason, registered funds of hedge funds (and their affiliates) typically purchase a class of nonvoting securities of the underlying fund or contractually waive their voting rights when investing in private funds.

5. Although Section 17(a) generally prohibits a registered fund from purchasing securities from or selling securities to an affiliated person of its investment adviser (including private investment funds managed by the registered fund's investment adviser), such transactions are permitted by Rule 17a-7 under the 1940 Act, subject to certain conditions, in the case of securities for which market quotations are readily available if the registered fund is affiliated with the other party to the transaction solely by reason of having the same investment adviser (or an affiliated adviser), or

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having common directors and/or common officers. Rule 17a-7 may not be available to permit cross-trades between a registered fund and a private fund where the funds are affiliated as a result of the adviser of the fund serving as general partner or owning 5 percent or more of the interests in the private fund.

6. Section 17(e)(1) of the 1940 Act generally makes it unlawful for any affiliate of a registered fund to accept from any source any compensation for acting as agent in connection with the purchase or sale of any property to or for the registered fund, except in the course of its business as an underwriter or broker.

   (a) Section 17(e)(2) of the 1940 Act and Rule 17e-1 thereunder permit the payment of commissions to an affiliated broker-dealer to effect securities transactions on an agency basis, subject to a condition that the commissions paid to the affiliated broker not exceed the "usual and customary" broker's commission.

   (b) Because of the prohibition of Section 17(e)(1), the adviser of a registered fund (which is deemed to be acting as the fund's agent in placing brokerage orders) may not use the registered fund's brokerage commissions to obtain any service or other benefit other than research services falling within the safe harbor of Section 28(e) of the 1934 Act.

C. Leverage and Use of Derivatives

1. Many registered alternative funds use short sales and derivatives in connection with their investment programs. These practices may be deemed to result in the issuance of "senior securities" subject to the limitations of Section 18 of the 1940 Act.

2. Generally, Section 18 of the 1940 Act imposes a 300-percent asset coverage requirement on closed-end funds with respect to the issuance of senior securities constituting indebtedness (which means that a fund needs $3 in total assets to cover $1 of borrowings). Section 18(f) of the 1940 Act generally prohibits the issuance of senior securities by open-end funds, but permits such funds to borrow from a bank subject to maintaining 300-percent asset coverage.

3. BDCs are subject, under Section 61 of the 1940 Act, to a 200-percent asset coverage requirement with respect to borrowings and the issuance of senior securities.

4. Under interpretations issued by the SEC and its staff, an investment position of a fund constitutes a senior security for 1940 Act purposes if it creates a potential future payment or delivery obligation on the part of the fund. Transactions that are viewed as creating senior securities include: short sales, writing options, futures transactions, swaps, forwards, reverse repurchase agreements and when-issued commitments. However, generally, these transactions are not deemed to be senior securities if a fund segregates on its books (or with its custodian bank) liquid assets having a value (marked-to-market daily) at least equal to the amount of its potential obligations.[3]

5. Some registered alternative funds use derivatives to facilitate implementation of investment exposures that they might not otherwise be able to achieve consistent with 1940 Act restrictions.

6. On Dec. 11, 2015, the SEC issued a release proposing to adopt new Rule 18f-4 under the 1940 Act.[4] The proposed rule, if adopted, will regulate the use of derivatives by registered funds and BDCs and

[3] *See,* e.g., *Securities Trading Practices of Registered Investment Companies*, ICA Rel. No. 10666 (April 18, 1979); *Dreyfus Strategic Income* (pub. avail. June 22, 1987); *Robertson Stephens Investment Trust* (pub. avail. Aug. 24, 1995); and *Merrill Lynch Asset Management, L.P.* (pub. avail. July 1, 1996).

[4] *Use of Derivatives by Registered Investment Companies and Business Development Companies,* ICA Rel. No. 31933 (Dec. 11, 2015).

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will also regulate other trading practices of such funds that are deemed to involve the issuance of "senior securities," including short sales of securities. It will also establish overall limits on the use of leverage whether obtained through borrowings, derivatives or other transactions.

(a) The SEC's goal in proposing the rule is to provide a clearer regulatory framework applicable to the use of derivatives by regulated funds. As explained in the SEC release, Rule 18f-4 is "designed to address the investor protection purposes and concerns underlying section 18 [of the 1940 Act] and to provide an updated and more comprehensive approach to the regulation of funds' use of derivatives transactions."

(b) The proposed rule would, subject to various conditions, provide regulated funds with an exemption from Section 18's restrictions on the issuance of "senior securities" in connection with effecting derivatives and financial commitment transactions. However, it would impose new limitations on the use of derivatives and other practices, and would modify the asset segregation requirements that funds need to meet. If adopted, the provisions of the rule will supersede prior guidance of the SEC and its staff relating to these matters.

D. Trade Allocations

1. Investment advisers have a fiduciary duty to treat all clients fairly. Thus, an advisory firm that manages both traditional mutual funds (or other "long only" accounts), as well as funds or other accounts that pursue alternative investment strategies, needs to assure that its trade allocation policies appropriately address conflicts that may exist as a result of differing trading strategies or as a result of the fact that the firm receives greater compensation for managing funds and accounts that use alternative investment strategies (possibly including performance-based fees or allocations). The conflict is particularly acute in circumstances where the same portfolio managers have responsibility for both types of accounts and where investment personnel have a direct participation in revenues derived from accounts that they manage.

2. One way to mitigate these conflicts is to establish information barriers between personnel involved in managing hedge funds (or other alternative strategy accounts) and other investment personnel within the firm. However, this approach is not always feasible or practicable.

3. If information barriers are not established, trade allocation procedures must be implemented to assure that no client accounts are disadvantaged where there are non-pro rata allocations of trades (e.g., the firm's hedge funds purchase or sell a security that is not also purchased or sold by the firm's registered funds) and to deal with conflicts arising from the fact that short sales effected for certain accounts may adversely affect other accounts (e.g., the firm's hedge funds selling short a security held long by the firm's registered funds). These procedures should also address other trading practices that might be viewed as unfair to any client (e.g., a hedge fund purchasing a thinly traded security shortly after significant sales of the same security by the registered fund).

(a) Procedures should require either: (i) independent approval of specified types of transactions (i.e., approval by someone other than the portfolio manager); or (ii) the preparation by the portfolio manager of a contemporaneous memorandum of the trading decision which sets forth the rationale for the trade and the differing decisions made for different clients.

(b) Back-end monitoring of trading should be used to monitor compliance with procedures and to identify potentially abusive practices.

4. A firm's trade allocation policies should be disclosed in its Form ADV, and appropriate disclosure should also be included in a fund's offering documents.

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E. Co-investments

1. Rule 17d-1 generally prohibits an affiliated person of a registered fund or a BDC (or an affiliated person of such a person) from participating in any transaction in connection with any "joint enterprise or other joint arrangement or profit-sharing plan" in which the registered fund or the BDC is also a participant absent an order issued by the SEC permitting such transaction.

2. The SEC staff takes the position that co-investments in privately placed securities made by a registered fund and other accounts managed by the fund's adviser may be prohibited by Rule 17d-1.[5] However, in a letter to Massachusetts Mutual Insurance Company ("MassMutual"), the staff took a no-action position allowing co-investments in privately placed securities, subject to certain conditions. One of those conditions is a requirement that no terms of the transaction are negotiated other than "price."

3. Because BDCs generally invest in privately negotiated transactions and are often part of a complex of other private or registered funds managed by the same adviser (i.e., affiliated persons of the BDC) that seek to participate in the same investment transactions, BDCs must be cognizant of the joint transaction prohibitions of Section 57(a)(4) of the 1940 Act and Rule 17d-1. To facilitate the ability to engage in these transactions, many BDCs have applied for and obtained SEC orders pursuant to Section 57(a)(4) and Rule 17d-1 permitting co-investments, subject to various conditions.

F. Use of Side Letters

Investors in hedge funds and other private investment funds sometimes enter into "side letters" with the managers of these funds to obtain various rights that are not given to all investors (e.g., more favorable withdrawal rights, reduced fees, transparency and indemnification rights). When the adviser of a registered fund of hedge funds also manages one or more unregistered funds of hedge funds, the use of side letters may raise an issue under Rule 17d-1 under the 1940 Act because of the position expressed by the SEC staff in the MassMutual letter. The compliance programs of registered funds of hedge funds should include policies and procedures to address this potential issue.

G. Valuation Issues

1. Some alternative investment strategies may involve the purchase of investments that are illiquid or otherwise hard to value. These may include investments in privately placed (or restricted) securities, thinly traded securities, interests in private investment funds or complex derivatives.

2. Valuation of investments and related internal controls is an area of SEC regulatory focus and has been the subject of SEC enforcement actions.[6]

3. Interests in hedge funds and other private investments are illiquid and market quotations for these securities are not available. Section 2(a)(41) of the 1940 Act requires that these investments be valued at their "fair value," as determined in good faith by the board of directors of a registered fund.

4. Registered funds and BDCs must adopt procedures governing the valuation of securities for which market quotations are not readily available. These procedures should identify the factors and methodologies that will be used to value the specific types of investments that are held by a fund.

[5] *Massachusetts Mutual Insurance Company* (pub. avail. June 7, 2000).

[6] *See,* e.g., *In the Matter of Morgan Asset Management, Inc., et al.*, ICA Rel. No. 29704 (June 22, 2011); *In the Matter of Calvert Investment Management, Inc.*, ICA Rel. No. 32321 (Oct. 18, 2016).

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5. A registered fund investing in hedge funds will generally have to rely on valuation information supplied by the managers of the underlying private funds in which the registered fund invests. Because transparency to the underlying hedge fund portfolios is not always available, the adviser of a registered fund may have no means of verifying the valuations provided by the underlying private funds.

   (a) In its September 2003 report, *Implications of the Growth of Hedge Funds*, the SEC staff recommended that the SEC adopt a rule under the 1940 Act prohibiting registered funds from investing in hedge funds unless their boards of directors adopt procedures designed to ensure that interests in hedge funds are valued consistently with the requirements of the 1940 Act.

   (b) The SEC has not proposed the adoption of such a rule. However, comments of the SEC staff given in connection with its reviews of registration statements filed by registered funds of hedge funds have essentially required the adoption of procedures addressing the valuation of interests in hedge funds.

H. New Liquidity Risk Management Rule

1. In October 2016, the SEC adopted Rule 22e-4, which requires mutual funds (other than money market funds) and ETFs that are organized as open-end funds to establish liquidity risk management programs designed to ensure they are able to meet redemption requests without materially affecting remaining investors' interests in the fund. Mutual funds and open-end ETFs must adopt and implement liquidity risk management programs that are reasonably designed to assess, manage and periodically review liquidity risk.[7] The compliance date for new Rule 22e-4 is Dec. 1, 2018 for fund complexes with net assets of $1 billion or more, and June 1, 2019 for fund complexes with less than $1 billion of net assets.

2. Rule 22e-4 also: (i) requires the classification of the liquidity of each of a fund's investments into one of four categories, ranging from highly liquid investments to illiquid investments; (ii) requires a fund to establish a "highly liquid investment minimum" (i.e., the percentage of a fund's assets that will be invested in highly liquid investments), unless the fund invests primarily in highly liquid investments; (iii) prohibits the acquisition of any illiquid investment if more than 15 percent of a fund's net assets would be invested in illiquid investments; and (iv) requires policies and procedures relating to redemptions in-kind (for funds that have the ability to make payment for redemptions by distributing portfolio securities).

3. A fund's board of directors is required, among other things: to approve the fund's liquidity risk management program; to designate a person or persons (which may be the fund's investment adviser, but may not solely be portfolio managers of the fund) to administer the program; to review, at least annually, a written report that addresses the operation of liquidity risk management program and assesses its adequacy and effectiveness; to approve any change in fund's highly liquid investment minimum (if the change is to be made when there is a shortfall in the fund's highly liquid investments); and to oversee the fund's illiquid investments if the 15-percent limit on illiquid investments is exceeded.

4. Funds will be required to include information relating to the liquidity of their investments in reports filed with the SEC on new Forms N-PORT and N-LIQUID.

[7] Unit Investment Trusts ("UITs"), including ETFs organized as UITs, are not subject to the requirement of Rule 22e-4 to establish liquidity risk management programs and are not subject to various related requirements of the rule. However, the rule requires that a UIT's principal underwriter or depositor engage in a limited liquidity review to determine that the portion of the UIT's portfolio comprised of illiquid investments is consistent with the redeemable nature of the securities the UIT issues.

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(a) Monthly reports on Form N-PORT will require a fund to provide information to the SEC on: (i) the liquidity classification of each of its investments; (ii) the aggregate investment liquidity of its portfolio; and (iii) its highly liquid investment minimum. Aggregate portfolio liquidity information will be publicly available (on a delayed basis). However, other liquidity related information will not be publicly available.

(b) A fund must file a report on Form N-LIQUID with the SEC (which will not be publicly available) within one business day if its holdings of illiquid investments exceed 15 percent of its net assets or if its highly liquid investments fall below the fund's highly liquid investment minimum for more than seven consecutive days. If a fund reports that it has exceeded the 15-percent limit on illiquid investments, it is required to make another filing on Form N-LIQUID when the fund's illiquid investments go below the limit.

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Attachment A: Comparison of U.S. Alternative Fund Structures

	Domestic Hedge Fund	**Domestic Private Equity Fund**	**Closed-end Fund/Non-publicly Traded**	**Closed-end Fund/Publicly Traded**	**Publicly Traded Business Development Company**	**Mutual Fund**
Typical Investments	Primarily liquid investments	Primarily illiquid investments (equity, debt or other assets)	May include liquid or illiquid investments (equity, debt or other assets)	May include liquid or illiquid investments (equity, debt or other assets)	Primarily illiquid equity or debt of private companies (and securities of micro-cap companies)	Primarily liquid investments. 15-percent limit on the purchase of Illiquid investments
Key Restrictions on Investments	None	None	Leverage limitation (300-percent asset coverage on debt)	Leverage limitation (300-percent asset coverage on debt)	Leverage limitation (200-percent asset coverage)	Leverage limitation (300-percent limitation on debt; only "senior securities" may be bank borrowings)
Form of Entity	Partnership or LLC	Partnership or LLC	Corporation, trust, partnership or LLC	Corporation or trust	Corporation or trust	Corporation or trust
Governance	General partner or managing member	General partner or managing member	General partner, managing member, directors or trustees	Directors or trustees	Directors or trustees	Directors or trustees
Tax Status	Partnership	Partnership	Partnership or Subchapter M	Subchapter M	Subchapter M	Subchapter M
1940 Act Status	Excluded by Section 3(c)(1) or 3(c)(7)	Excluded by Section 3(c)(1) or 3(c)(7)	Registered	Registered	Subject to BDC provisions of the 1940 Act	Registered
Manner of Offering	Private offering	Private offering	Public or private offering	Public offering	Public offering	Public offering
Investor Qualification Requirements	Accredited investors, qualified purchasers	Accredited investors, qualified purchasers	Accredited investors (if privately offered)	No restrictions	No restrictions	No restrictions
Performance-based Allocation or Fee	Yes	Yes	Yes (if investors are limited to "qualified clients")	No	Yes (without requirement that investors be "qualified clients")	No

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	Domestic Hedge Fund	**Domestic Private Equity Fund**	**Closed-end Fund/Non-publicly Traded**	**Closed-end Fund/Publicly Traded**	**Publicly Traded Business Development Company**	**Mutual Fund**
Liquidity	Periodic (quarterly, semi-annually or annually, potentially with lock-ups and/or gates)	None; fund typically has seven- to 10-year term	Periodic repurchase offers (not more frequently than quarterly)	Exchange-traded	Exchange-traded	Daily liquidity at current NAV

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