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United States
ALTERNATIVE INVESTMENT FUNDS

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This country-specific Q&A provides an overview of alternative investment funds laws and regulations applicable in United States.

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UNITED STATES
ALTERNATIVE INVESTMENT FUNDS

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

Privately offered alternative investment funds ("AIFs") are established in the United States (U.S.) pursuant to U.S. state law. AIFs are most commonly organized under state law as a limited partnership ("LP") or a limited liability company ("LLC"). In particular, sponsors primarily organize AIFs in the State of Delaware because this jurisdiction is deemed by many industry participants to have pro-management laws, a sophisticated Court of Chancery with respect to corporate matters, and a well-established related body of statutory and case law.

In addition, it is common for AIFs that are organized in a non-U.S. jurisdiction (e.g., the Cayman Islands, British Virgin Islands, Bermuda) to be marketed in the United States. For purpose of this survey, we will primarily refer to the laws of the State of Delaware in connection with the organization, structure and operation of an AIF sold to U.S. residents.

2. Does a structure provide limited liability to the investors? If so, how is this achieved?

Under Delaware law, so long as an investor is not actively involved in the management or operations of an AIF, such investor has limited liability. Typically, the governing agreement of an AIF provides that investors do not have any rights over the day-to-day management or operations of an AIF. Accordingly, the maximum amount that a passive investor of an AIF can lose is the total amount of its investment in such AIF.

3. Is there a market preference and/or most preferred structure? Does it depend on asset class or investment strategy?

A Delaware limited partnership is the traditional and most common vehicle for establishing an AIF in the United States across multiple asset classes and investment strategies. Limited partnerships have the most developed body of law in Delaware where AIFs are typically organized. In addition, AIF investors are most familiar with investing in Delaware limited partnerships. A Delaware limited liability company is the second most common vehicle for establishing an AIF in the United States.

It should also be noted that it is common for sponsors to form a non-U.S. feeder fund as a corporate tax blocker for certain non-U.S. investors or U.S. tax-exempt investors.

4. Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds or strategies (e.g. private equity vs. hedge)) and, if so, how?

No, The AIF can be open-ended or closed-ended based on the structure of the organizational documents.

5. Are there any limits on the manager's ability to restrict redemptions? What factors determine the degree of liquidity that a manager offers investor of an Alternative Investment Fund?

No, there are no limitations. The primary factor in determining the liquidity profile of an AIF is the portfolio of underlying assets held by that AIF. Neither U.S. federal nor Delaware state law does limits the extent to which investor redemptions may be restricted for an AIF.

6. What are potential tools that a manager may use to manage illiquidity risks

regarding the portfolio of its Alternative Investment Fund?

Potential tools to manage illiquidity risks include redemption notice periods, redemption fees, investor or fund-level redemption gates, lock-up periods, temporary suspension of redemptions, redemptions in-kind and side pockets. The foregoing provisions should be expressly set forth in the AIF's governing agreement in order to be utilized by the sponsor.

7. Are there any restrictions on transfers of investors' interests?

Yes. Rule 502(d) of Regulation D under the U.S. Securities Act of 1933, as amended (the "Securities Act") provides that securities acquired pursuant to a private placement under Regulation D cannot be resold by an investor without registration under the Securities Act or an exemption therefrom. In addition, in order for an AIF to rely on Regulation D under the Securities Act, the sponsor must exercise reasonable care to assure that investors are not investing in the AIF with a view to re-distributing interests in the AIF to the public. Accordingly, it is market practice for the governing agreement of an AIF to require investors to obtain the prior written consent of the sponsor in order to transfer an investment in such AIF.

8. Are there any other limitations on a manager's ability to manage its funds (e.g., diversification requirements)?

No, there are no limitations other those set in the AIF organizational documents or operating agreement with shareholders/limited partners. Under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), an investment adviser is deemed, however, to owe a fiduciary duty to its clients. This fiduciary duty under the Advisers Act is comprised of a duty of care and a duty of loyalty. This means that an investment adviser must, at all times, serve the best interest of its client and not subordinate its client's interest to its own. In addition, an investment adviser must eliminate or make full and fair disclosure of all conflicts of interest.

9. What is the local tax treatment of (a) resident, (b) non-resident, and (c) pension fund investors (or any other common investor type) in Alternative Investment Funds? Does the tax treatment of the target investment dictate the structure of the Alternative Investment Fund?

U.S. citizens and residents are subject to taxation on worldwide income. Non-residents are taxable directly on net income derived in connection with U.S. trade or business activity and through withholding on the gross amount of dividends and other categories of U.S. source income not connected with a U.S. trade or business. U.S. tax-exempt investors generally are taxable only on income derived from (i) a business that is unrelated to their exempt purpose (with certain exclusions) or (ii) debt-financed property. The tax status or preference of investors, as well as the target investments for an AIF, may affect the structure that is ultimately established.

10. What rights do investors typically have with respect to the management or operations of the Alternative Investment Fund?

Typically, investors do not have any rights over the day-to-day management or operations of an AIF. However, the governing agreements for some AIFs may provide investors with the right, under limited circumstances and upon majority or supermajority vote, to remove the sponsor or manager of the AIF, terminate the AIF or suspend additional investments. In addition, pursuant to its fiduciary duty under the Advisers Act, an investment adviser should consider obtaining the prior consent of AIF investors (or an advisory board comprised of investor representatives) with respect to certain transactions or arrangements involving a conflict of interest.

11. Where customization of Alternative Investment Funds is required by investors, what types of legal structures are most commonly used?

If, for certain reasons, a separate vehicle is required to be established that is specifically tailored for investors' needs, such separate vehicle will usually be structured in the form of a feeder vehicle, a parallel vehicle or a special purpose vehicle, and depending on the circumstances can be structured in the form of a separate corporate entity, LP or LLC.

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

Yes. The Advisers Act generally requires persons that meet the definition of an "investment adviser" (as defined in Section 202(a)(11) of the Advisers Act) to register with the U.S. Securities and Exchange Commission (SEC), unless an exemption from such requirement applies. Two exemptions in particular are useful to advisers that wish to manage AIFs that are marketed in the United States.

Foreign Private Adviser Exemption: Under Section 202(a)(30), a "foreign private adviser" is defined as an investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 U.S. clients and U.S. investors in private funds advised by the investment adviser (such clients and investors, "U.S. Persons"); (iii) has aggregate assets under management attributable to U.S. Persons of less than $25 million; and (iv) neither (a) holds itself out generally to the public in the U.S. as an investment adviser, nor (b) advises investment companies or business development companies registered under the Company Act.

Private Fund Adviser Exemption: An exemption exists for investment advisers that solely manage "private funds" (and not, for example, separately managed accounts for U.S. persons) with assets under management in the U.S. of less than $150 million. In applying this exemption, Rule 203(m)-1 under the Advisers Act requires non-U.S. advisers (that is, advisers with their "principal office and place of business" outside the U.S.) to count only private fund assets that are managed from a "place of business" within the United States toward the $150 million threshold (while it requires U.S. advisers to consider all of their asset management activities worldwide). A non-U.S. adviser can qualify for this exemption regardless of the size or nature of its activities outside of the United States, provided that all of its clients that are U.S. Persons are qualifying private funds (as defined by the exemption).

Investment advisers that rely on the "private fund adviser" exemption are called "exempt reporting advisers" under SEC rules, and are required to submit to the SEC, and update at least annually, certain reports on Part 1 of Form ADV. These advisers are subject to a limited subset of rules and regulations under the Advisers Act.

In addition, it should be noted that in February 2022, the SEC voted to propose a set of new rules and rule amendments under the Advisers Act that collectively, if adopted, would represent the most significant changes to the regulation of AIFs and their investment advisers since the Dodd–Frank Act ("Proposed Private Fund Adviser Rules"). The Proposed Private Fund Adviser Rules, if adopted as proposed, are likely to result in significant burdens on the U.S. private AIF industry and disrupt the traditional relationship between AIF advisers and AIF investors, including, (i) requirements on AIFs to produce quarterly statements; (ii) requirements on AIFs to conduct audits; (iii) in connection with adviser-led secondaries, require AIF advisers to obtain a fairness opinion and distribute it to investors, along with a summary of material business relationships between the AIF adviser and the opinion provider; and (iv) prohibit AIF advisers from engaging in certain activities (e.g., related to entering into certain side letter arrangements, certain sales practices, conflicts of interest, expenses charged to private funds and compensation arrangements). The Proposed Private Fund Adviser Rules would also limit an AIF adviser's ability to be indemnified for negligence or recklessness in providing services to the AIF. As of the date of this publication, the Proposed Private Fund Adviser Rules are still pending. See https://www.sec.gov/news/press-release/2022-19.

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

Generally speaking, AIFs that are privately offered in the United States are structured in reliance on Section 3(c)(1) or 3(c)(7) of the U.S. Investment Company Act of 1940, as amended (the "Company Act"), which each provide an exemption from public offering registration as an investment company with the SEC under the Company Act. Sections 3(c)(1) and 3(c)(7) require that the AIF must not conduct a public offering of its securities in the United States. Section 3(c)(1) limits the number of beneficial owners in an AIF to no more than 100. Section 3(c)(7) does not impose any limits on the number of beneficial owners but limits investors to those meeting the definition of a "qualified purchaser".

14. Does the Alternative Investment Fund require a manager or advisor to be domiciled in the same jurisdiction as the Alternative Investment Fund itself?

No.

15. Are there local residence or other local qualification or substance requirements for the Alternative Investment Fund and/or the manager and/or the advisor to the fund?

No, but Delaware limited partnerships and limited liability companies must appoint an agent for service of process in Delaware, and must make the necessary local tax filings. In addition, applicable state law may require such manager or advisor to be qualified in the state in which such AIF is domiciled or has its principal place of business.

16. What service providers are required by applicable law and regulation?

AIFs would generally engage an investment manager, administrator, custodian and auditor. Certain AIFs may also appoint prime brokers and valuation agents.

17. Are local resident directors / trustees required?

No.

18. What rules apply to foreign managers or advisers wishing to manage, advise, or otherwise operate funds domiciled in your jurisdiction?

Foreign managers and advisers that operate AIFs in the United States must either be registered as an investment adviser with the SEC or fit within an exemption such as registration (see Item 12 above). Foreign managers and advisers must also comply with regulations of the Commodity Futures Trading Commission if the AIF invests in “commodity interests”.

19. What are common enforcement risks that managers face with respect to the management of their Alternative Investment Funds?

The SEC’s Division of Examinations publishes annual examination priorities and periodic risk alerts to identify the areas it believes present potential risks to investors. Common themes include sponsors’ failure to disclose conflicts of interest, improper allocation of fees and expenses, information security, and deficient policies and procedures related to material nonpublic information.

20. What is the typical level of management fee paid? Does it vary by asset type?

The range of “market” management fee rates can vary depending on an AIF’s size and strategy. In practice, we typically see the rate ranging, on average, from 1.0% to 2.0% of the net asset value of the AIF.

21. Is a performance fee typical? If so, does it commonly include a “high water mark”, “hurdle”, “water-fall” or other condition? If so, please explain.

Yes, due to different tax implications, performance-based compensation can appear in the form of a “performance fee”, “performance allocation” or “carried interest”. In practice, we typically see the rate ranging, on average, from 15% to 20% of the net profits of the AIF.

Open-ended AIFs typically charge a performance fee or allocation on an annual basis on both realized and unrealized gains. It is very common for such performance allocation to be subject to a “high water mark” (sometimes referred to as a loss carryforward), which mandates that the performance fee or allocation will only be charged if the value of the AIF exceeds the previous highest value achieved by the AIF. Sponsors may also require that the AIF’s performance for a given year must exceed an additional hurdle rate (e.g. 5% of NAV) above that high water mark in order for the performance fee or allocation to be charged.

Closed-ended AIFs typically charge carried interest pursuant to a “distribution waterfall,” whereby distributions from realized investments are distributed to investors and the sponsor according to an established priority that is set forth in the governing agreement of the AIF. Such priority typically involves a “preferred return” that entitles a minimum return to investors before the sponsor may begin receiving carried interest.

22. Are fee discounts / fee rebates or other economic benefits for initial investors typical in raising assets for new fund launches?

Yes, this is a typical arrangement for certain AIFs whose sponsors are seeking to enhance fundraising efforts for such AIFs. This may be structured as a separate share class.

23. Are management fee “break-points” offered based on investment size?

Reduced management fee rates may be given based on investment size, strategic relationship status or early investment.

24. Are first loss programs used as a source of capital (i.e., a managed account into which the manager contributes approximately 10-20% of the account balance and the remainder is furnished by the investor)?

No.

25. What is the typical terms of a seeding / acceleration program?

Sponsors that are launching an AIF often accept long-term seed investment in their AIFs from large institutional investors in exchange for such investors receiving a significant fee discount and a percentage of the sponsor's revenue. An acceleration program works similarly, but is committed to an existing AIF seeking to accelerate asset growth.

26. What industry trends have recently developed regarding management fees and incentive/performance fees or carried interest? In particular, are there industry norms between primary funds and secondary funds?

We have recently seen a downward pressure from 2.0% management fee rates and 20% incentive/performance fee or carried interest rates charged by primary AIFs. With respect to secondary AIFs, in a typical structure, an investor is charged a management fee and incentive/performance fee or carried interest by the AIF, which, in turn, must pay a fee to the sponsor of the acquired underlying fund interests.

27. What restrictions are there on marketing Alternative Investment Funds?

An AIF must be offered and sold in the United States pursuant to a private placement in order for its securities to be exempt from registration under the Securities Act.

Private placements issued by AIFs are typically made under the Rule 506(b) safe harbor of Regulation D, which permits sales to an unlimited number of "accredited investors" and up to 35 non-accredited investors (although the sale to non-accredited investors trigger additional disclosure requirements). To rely on this safe harbor, (i) no general solicitation or advertising may occur, and (ii) reasonable resale restrictions must be imposed.

Private placements issued by AIFs are much less commonly made under Rule 506(c) safe harbor of Regulation D, which permits general solicitation and general advertising. To rely on this safe harbor (among other requirements), reasonable steps must be made to verify that the purchasers are accredited investors.

In addition, Regulation D also technically requires an AIF to file a short notice (a Form D) with the SEC within 15 days of the first sale of interests to U.S. investors.

28. Is the concept of "pre-marketing" (or equivalent) recognised in your jurisdiction? If so, how has it been defined (by law and/or practice)?

No.

29. Can Alternative Investment Funds be marketed to retail investors?

No.

30. Does your jurisdiction have a particular form of Alternative Investment Fund be that can be marketed to retail investors (e.g. a Long-Term Investment Fund or Non-UCITS Retail Scheme)?

No.

31. What are the minimum investor qualification requirements for an Alternative Investment Fund? Does this vary by asset class (e.g. hedge vs. private equity)?

All investors in an AIF must generally qualify as "accredited investors" as defined in Rule 501(a) under the Securities Act. An "accredited investor" is generally: (i) a natural person whose net worth (or joint net worth with that person's spouse or spousal equivalent) exceeds $1 million (excluding the value of the individual's primary residence), or whose income was in excess of $200,000 in each of the preceding two years (or, together with that person's spouse or spousal equivalent, in excess of $300,000 in each of the preceding two years) and who reasonably expects to reach the same level of income in the current year; (ii) a natural person holding in good standing a Series 7, 65 and/or 82 license and/or such other professional certification(s) or designation(s) or credential(s) from an accredited educational institution that the SEC has designated as qualifying an individual for accredited investor status; (iii) a natural person who is a “knowledgeable employee” as defined under the Company Act; or (iv) any entity with total assets in excess of $5 million.

In addition, investors in AIFs relying on the Section 3(c)(7) exemption from registration under the Company Act must meet the definition of a “qualified purchaser”, which is generally: (i) a natural person who owns at least $5 million in investments; (ii) a natural person who is a “knowledgeable employee” as defined under the Company Act and (iii) any entity that owns and invest on a discretionary basis at least $25 million in investments.

For U.S. AIFs, all investors must meet the qualification requirements; for non-U.S. AIFs, only U.S. investors must meet these qualification requirements.

32. Are there additional restrictions on marketing to government entities or similar investors (e.g. sovereign wealth funds) or pension funds or insurance company investors?

The SEC has adopted the “pay-to-play” rule (Rule 206(4)-5 under the Advisers Act) which prohibits investment advisers from providing advisory services for compensation to a government entity (which includes managing an AIF in which the government entity is an investor) within two years following a contribution to an official of the government entity by the adviser or certain “covered associates”.

In addition, many states have adopted similar rules and regulations.

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

Offering and selling interests in an AIF in the United States generally requires that the AIF engage an entity that is registered as a broker-dealer with the SEC and that is a member of FINRA. The licensed broker-dealer may be either an affiliate of the AIF sponsor or an independent third-party. Some AIF sponsors rely on the so-called “issuer exemption.” The SEC has adopted a safe harbor under Rule 3a4-1 of the Exchange Act, which deems persons within the Rule to be eligible for the exemption, but the precise contours of this exemption are unclear.

34. Is the use of “side letters” restricted?

No, the use of side letters is not currently restricted under applicable U.S. federal or Delaware state law.

However, it should be noted that if the Proposed Private Fund Adviser Rules are adopted in their current state, U.S. federal law would prohibit all AIF advisers from engaging in certain types of differential treatment of investors (i.e., entering into side letters in respect of certain preferential redemption rights or providing preferential information where there is a reasonable expectation such treatment could have “a material, negative effect” on investors), while prohibiting other types of differential treatment absent disclosure to current and prospective investors.

35. Are there any disclosure requirements with respect to side letters?

There are no express disclosure requirements under U.S. federal or state law with respect to side letters. However, from a conflicts disclosure perspective, investment advisers should include disclosure in the offering memorandum for an AIF that side letters may be entered into which result in preferential treatment for certain investors over others.

However, as noted above, the Proposed Private Fund Adviser Rules, if adopted, would add disclosure requirements with respect to side letters.

36. What are the most common side letter terms? What industry trends have recently developed regarding side letter terms?

The most common side letter terms include most favored nations, reduced or modified fees, preferential redemption rights, transfer rights, enhanced reporting, and confidentiality.

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