USA

Law and Practice

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Winston & Strawn

Contents

Winston & Strawn has served as a trusted adviser and advocate for clients across virtually every industry for more than 170 years. Its national funds practice advises private fund sponsors, alternative asset managers, funds of funds, pension plans, family offices, and institutional investors on all aspects of their fund formation transactions. The practice also addresses special situations, sponsor separations, fund restructurings and other GP-led secondary transactions. The practice is also among the most active in LP secondaries transactions by volume, representing both buyers and sellers on secondary transactions, as well as lead and syndicate LPs on their investments in continuation funds, tender offers, and other GP-led secondaries transactions. Winston & Strawn also has the nation's leading SBIC practice, the largest by market share, advising on 60-70% of the USD41 billion annual programme, reflecting consistent growth and prominence in the sector. The firm's transactional capabilities are supported by its financial services, regulatory, tax, and compliance capabilities, including SEC regulatory and compliance issues and SEC examinations.

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1. General

1.1 General Overview of Jurisdiction

The United States is the world's largest and most predominant jurisdiction for the formation of alternative funds and boasts the largest number of alternative asset managers in the world. In recent U.S. Securities and Exchange Commission (SEC) filings, investment advisers have reported more than USD25 trillion in private fund gross asset value, amongst tens of thousands of funds.

Under the US federal securities laws, US investment advisers are governed by a robust regulatory framework, although certain exemptions may apply. In addition, the US federal securities laws cover many aspects of fund formation and the offerings of fund interests. Other US federal and state rules may apply depending on a number of factors, including the nature of the fund's investment activities and/or the advisory activities of an investment adviser.

1.2 Key Trends

The regulatory landscape for private funds continues to grow more complex, with new rules and regulations adopted and proposed by the SEC and other regulatory authorities. Significant new rules include those relating to beneficial ownership reporting, the protection of customer information and advertisements and marketing communications, and proposed rules include those addressing conflicts of interest in predictive data analytics, the safeguarding of customer assets, outsourcing and cybersecurity risk management.

2. Funds

2.1 Types of Alternative Funds and Structures

Alternative funds are formed to accommodate a variety of investment strategies. Generally, structures will be tailored to meet the business and legal needs of both the investment adviser and its investors. The strategies of "closed-end" private funds will typically be structured to target investments in one or more segments of a company's capital stack, such as:

- venture capital funds, which typically invest in early and development-stage companies;
- growth equity funds, which typically invest in later-stage, pre-IPO companies or in "PIPE" transactions with public companies;
- buyout funds, which typically acquire controlling interests in companies with an eye towards later selling those companies or taking them public;
- distressed funds, which typically invest in debt securities of financially distressed companies at a discount; and
- credit funds, which typically target debt securities in companies (focusing on a variety of senior, mezzanine or other types of credit).

Open-ended funds will generally permit investors to invest or redeem their fund securities periodically, often subject to restrictions such as redemption gates or lock-ups. Open-ended funds will typically pursue a more liquid portfolio, although these structures can also be designed to accommodate illiquid investments.

Both closed- and open-ended alternative funds formed in the USA will typically involve several key entities, including:

- The fund: This is generally a pool of capital with no direct operations. Funds targeting US investments will typically be formed as Delaware limited partnerships or limited liability companies. Depending on the tax needs of the investors, US and non-US investors may invest in these structures directly or indirectly via one or more feeder vehicles or in parallel funds or other alternative fund structures. In the USA, Delaware is widely known as the "go-to" jurisdiction for entity formation given, among other things, its wide recognition, well-developed body of case law, robust legal protections, freedom to contract, and low startup costs. Also, its state courts are highly experienced in resolving complex business disputes and generally known for respecting the freedom to contract. Other US states or non-US jurisdictions will be used where appropriate to accommodate particular tax, regulatory or other legal needs.
- A general partner or other managing entity (eg, managing member or manager): They have the legal power to act on behalf of the fund.
- A management company or investment adviser: They are appointed to provide investment advisory services to the fund, employ the investment team, provide management or investment advisory services and generally manage the day-to-day operations of the fund.
- Other related entities may be formed to accommodate the tax, regulatory and other legal needs of the investment adviser or the fund and its investors.

2.2 Regulatory Regime for Funds

Alternative funds and investment advisers are subject to a variety of regulations under US federal and state laws. The below outlines the basic US federal regulatory regime for alternative funds; depending on the facts and circumstances, other rules may apply.

U.S. Securities Act of 1933 (the "Securities Act")

Alternative funds are subject to the US rules concerning private placements when interests are offered to US persons, or US jurisdictional means are otherwise used in connection with an offering. Offers and sales of securities in the United States generally may only be made pursuant to a registration statement filed with, and declared effective by, the SEC, or in accordance with an exemption from these registration requirements. Alternative funds typically rely on the registration exemption provided by Section 4(a)(2) of the Securities Act, and the "safe harbour" provided by Rule 506 under Regulation D under the Securities Act ("Regulation D"). Section 4(a)(2) is a private placement exemption available to issuers for sales of their securities "not involving any public offering." Section 4(a)(2) does not expressly provide details of what constitutes a valid private placement, so most alternative funds rely on the safe harbour provisions set forth in Regulation D. Rule 506(b) of Regulation D generally requires:

- Limitation on manner of offering: There should be no general advertising or "general solicitation".
- Limitations on resale:
  - (a) Offering materials should include special legends regarding US selling and transfer restrictions.
  - (b) Each purchaser should represent in the fund's subscription agreement that it is acquiring the interests for its own account and not with a view to resale or distribution thereof, and each purchaser should further undertake that it will only resell the interests in accordance with the Securi-

ties Act and the fund's transfer restrictions.

- Nature of and limitation on number of purchasers: Offers and sales of interests should only be made to institutions and individuals that qualify as "accredited investors" ("accredited investors"), as defined in Regulation D. Rule 506(b) does allow for offers and sales to up to 35 financially sophisticated investors so long as those non-accredited investors are provided with disclosures that are similar to what would be required in a public/registered offering.
- "Bad actor" disqualification: The fund, the general partner or the management company can be subject to disqualification if they have committed "bad acts". The fund itself can be disqualified if more than 20% of its securities are owned by investors who are "bad actors".
- SEC Filing: Form D must be filed with the SEC within 15 days of the fund's first sale of securities, and any annual amendments thereto must be filed while the offering is ongoing.

Rule 506(c) is a separate safe harbour that has no restrictions on the use of general advertising or general solicitation, but all investors must be "verified" as accredited investors. The overwhelming majority of alternative funds rely on Rule 506(b).

Offerings by US domiciled funds to non-US investors will generally be made in accordance with Regulation D. Offerings by non-US domiciled funds to non-US investors will generally be made in accordance with Regulation S under the Securities Act, which provides that registration under the Securities Act is not required when the offer and sale of a security occurs outside the United States in an offshore transaction and there are no directed selling efforts in the United States with respect to such sale.

U.S. Investment Company Act of 1940 (the "Investment Company Act")

The Investment Company Act regulates "investment companies", which are broadly defined as companies that engage primarily in "investing, reinvesting, owning, holding or trading in securities". To avoid being subject to the onerous requirements of operating as a registered investment company under the Investment Company Act, many alternative funds are structured to rely on certain exclusions from the definition of investment company. Most common are Section 3(c)(7) and Section 3(c)(1) of the Investment Company Act.

- Section 3(c)(7) provides an exclusion for a privately-offered fund whose interests are beneficially owned by "qualified purchasers". "Qualified purchasers" generally include (i) individuals, family-owned businesses, and trusts for family members that own USD5 million or more in "investments"; (ii) a trust (not addressed in (i)) that is not formed for the specific purpose of acquiring securities, as to which the trustee or other person authorised to make decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a qualified purchaser; (iii) entities that own and invest at least USD25,000,000 in investments; and (iv) entities exclusively owned by qualified purchasers.
- Section 3(c)(1) provides an exclusion where an issuer's securities are held by less than 100 beneficial owners. A fund structured under Section 3(c)(1) must adhere to various "anti-pyramiding" rules that are designed to prevent circumventing the 100 investor limit. Where a fund forms two parallel funds, one

a 3(c)(1) private investment fund with 100 or fewer non-qualified purchasers and the other a 3(c)(7) qualified purchaser fund with an unlimited number of qualified purchasers, the two funds are not integrated for purposes of determining whether the first qualifies under the applicable exemption.

U.S. Investment Advisers Act of 1940 ("Advisers Act")

See **3.3 Regulatory Regime for Managers**.

U.S. Commodity Exchange Act (CEA)

The CEA generally governs the futures and derivatives markets. In the United States, securities and futures are subject to separate regulatory regimes. The U.S. Commodity Futures Trading Commission (CFTC) and U.S. National Futures Association (NFA) serve as the derivative industry's regulatory and self-regulatory authorities. If a fund will trade any amount of exchange-traded futures contracts, options on futures contracts or swaps (collectively, "commodity interests") as part of its investment strategy, for all practical purposes, the fund will fall within the definition of a "commodity pool". The operator (ie, sponsor or general partner) of a commodity pool must register with the CFTC as a commodity pool operator (CPO) and must become a member of the NFA unless it can avail itself of an exemption. The investment manager to a commodity pool generally must register with the CFTC as a commodity trading adviser (CTA) and become an NFA member unless it can avail itself of an exemption. These registration requirements are generally subject to narrowly drawn exceptions or exclusions. See **2.3 Disclosure/Reporting Requirements** and **3.3 Regulatory Regime for Managers** for further information regarding CFTC registration.

U.S. Securities Exchange Act of 1934 ("Exchange Act")

The Exchange Act generally governs the issuers of registered securities and regulates broker-dealers. In general, under the Exchange Act, all sales of interests in a fund must either be made by the "issuer" (ie, the fund) or a registered broker-dealer. If there will be no independent selling agents and the fund will be making all sales, the broker-dealer registration requirement generally is not implicated, unless the issuer hires or otherwise employs marketing personnel whose compensation is tied to the sales made by them. See **4.5 Compensation and Placement Agents**.

ERISA

Under the Employee Retirement Income Security Act's (ERISA) Plan Asset Regulation, when "Benefit Plan Investors" acquire 25% or more of the equity interests in a fund, the Benefit Plan Investors are deemed to have an interest in the underlying assets of that investment, unless the investment meets one of the exceptions. These funds are typically referred to as "plan asset funds". Individuals responsible for the investment and management of plan asset funds are subject to ERISA's fiduciary responsibility provisions and certain prohibited transaction provisions under both ERISA and the U.S. Internal Revenue Code ("Code"). If these obligations are breached, the fund's sponsor and/or investment adviser can incur substantial liabilities and penalties. A Benefit Plan Investor is an (i) employee benefit plan subject to title I of ERISA; (ii) individual retirement accounts, Keogh Plans and other employee benefit plans that are not subject to ERISA but are subject to the prohibited transaction rules of Code §4975; and (iii) other entities the assets of which are deemed to be plan assets based on investment from entities listed in (i) and/or (ii) above.

State Regulation

Alternative funds and investment advisers will be required to comply with state securities laws (so-called blue sky laws) and related regulations, the application of which may (in part) be preempted by certain of the federal securities laws mentioned above.

2.3 Disclosure/Reporting Requirements

An investment adviser or management company that falls within the definition of "investment adviser" under the Advisers Act must register with the SEC, unless it (i) is prohibited from registering under the Advisers Act because it has less than USD25 million of regulatory assets under management and is regulated by state law or (ii) qualifies for an exception from the Advisers Act's registration requirement (see **3.3 Regulatory Regime for Managers**). A sponsor that registers with the SEC as an investment adviser will be required to, among other things:

- file a Form ADV with the SEC and keep it current by filing periodic amendments, including an annual amendment;
- comply with the "brochure rule", which requires most advisers to provide clients and prospective clients with information about the adviser's business practices and its principals' educational and business backgrounds;
- maintain accurate and current books and records and be subject to inspection and examination by the SEC staff;
- complete Form PF filings, which contain more detailed information on the funds it manages or advises, and which are required to be filed on an annual or quarterly basis or more frequently with respect to certain events;
- adopt and maintain written policies and procedures that are reasonably designed to prevent violations of the Advisers Act and related regulations and have a code of ethics governing employee behaviour (including personal trading reporting, and restrictions and enforcement of certain insider trading procedures);
- comply with the Marketing Rule (see **3.3 Regulatory Regime for Managers**); and
- only charge performance-based fees (ie, carried interest) to investors that are "qualified clients" as defined in Rule 205-3 under the Advisers Act.

CPOs and CTAs have specific filing and reporting requirements under the CEA, the CFTC's rules and the rules of the NFA.

Managers registered as CPOs must generally:

- distribute monthly or quarterly account statements to pool participants within 30 days of month-end or quarter-end;
- distribute an annual report to pool participants within 90 days of the pool's fiscal year-end; and
- file Form PQR with the NFA on a quarterly basis, providing specific information about the manager and the commodity pools that it operates.

Managers registered as CTAs must generally:

- file Form PR with the NFA within 45 days after the quarters ended March, June and September; and
- file a year-end report within 45 days of the calendar year end.

2.4 Tax Regime for Funds

No Entity-Level Income Tax on Flow-Through Funds

Typically, US-based funds are established as pass-through entities, such as partnerships or limited liability companies. Generally, a pass-through entity does not pay any entity-level income tax; instead, the beneficial owners of such pass-through entity report their share of the pass-through entity's income, which itself is reported by the pass-through entity to its beneficial owners on an Internal Revenue Service Schedule K-1 (and to the extent the fund has foreign income, on an Internal Revenue Service Schedule K-3), and pay applicable federal income taxes at rates specific to such beneficial owners. However, in certain circumstances, a fund could be deemed to be a "publicly traded partnership", subjecting it to federal income tax at the corporate income tax rate unless the fund satisfies an annual 90% "annual income" test.

Corporate Income Tax

In the unusual circumstance where a US fund is established as a corporation, such fund is subject to US federal income tax (currently 21%) and may be subject to state income tax. Additionally, some funds may elect to use a structure involving a below-the-fund or above-the-fund "blocker corporation" that would pay US federal income tax but may help tax-exempt and non-US investors avoid incurring unrelated business taxable income (UBTI) or effectively connected income (ECI), respectively (see **4.6 Tax Regime for Investors**).

2.5 Loan Origination

Permissible, Subject to State Lending Laws

Alternative funds are permitted to originate loans, but a state-by-state analysis should be considered to evaluate licensing risk.

State Licensing Laws

Certain states regulate both commercial and consumer lending. Because licensing requirements vary from state to state, alternative funds must consider their licensing risk on a state-by-state basis. Although there is no one-size-fits-all analysis, some relevant factors that are typically considered to determine whether licensing is required include:

- the purpose/type of loan;
- the amount of the loan;
- the frequency of the lender's lending activity (eg, the number of loans made in a 12-month period);
- the amount of interest charged on the loan;
- the location of the borrower;
- the location of the lender/location from where lender solicits loans; and
- the location of the collateral.

If licensing is required, a state regulator will generally require the fund to meet certain financial conditions and to submit a licensing application that includes the disclosure of certain minimum information. Although state requirements vary, licensing applications may require disclosure of information regarding the fund's business plan, financial information, and the fund's owners, parents, subsidiaries and affiliates.

State Usury Laws

States generally impose statutory limitations regarding the permissible amount of interest that a lender may charge on a loan. State statutes vary, but the type/purpose of the loan and the amount of the loan generally are two key factors considered in this analysis.

Tax Considerations

A fund that originates loans may be treated as being engaged in a US trade or business for US federal income tax purposes. In that case, non-US investors would be deemed to be engaged in a US trade or business as well, and would have to file US income and possibly state income tax returns and pay US federal and state tax.

2.6 Non-traditional Assets

There are no special limitations regarding the types of assets in which a fund may invest, although special US federal and/or state rules may apply, depending on the nature of the fund's assets. For example:

- Digital asset or cryptocurrency funds are typically structured utilising open-ended hedge fund structures. The SEC has clarified in guidance over the years that it will view these types of assets as "securities" and hence subject to US federal securities laws.
- Cannabis funds are typically structured utilising private equity fund structures. However, in determining the fund's domicile within the USA, fund sponsors should give due consideration to the various state-by-state differences in US state cannabis regulations, as well as the risks inherent in this strategy given that cannabis remains illegal under US federal law.
- Private credit funds that originate loans may be subject to applicable state regulations. See **2.5. Loan Origination**.

2.7 Use of Subsidiaries for Investment Purposes

Alternative fund structures can be utilised to accommodate the tax, regulatory and other legal needs of the investment adviser and the fund and its investors. For example, non-US investors who seek to avoid certain US tax filing obligations or other adverse tax consequences may invest in a fund via feeder funds that are treated as corporations for US federal income tax purposes or by investing directly or indirectly in parallel funds or alternative investment funds that utilise blocker corporations. See **2.4 Tax Regime** and **4.6 Tax Regime for Investors**.

2.8 Local/Presence Requirements for Funds

Generally, US states (including Delaware) do not require managers to have a local presence (or appoint local directors) to form an entity. Delaware, for example, only requires the entity to maintain a registered agent and registered office in Delaware (amongst other limited requirements). Depending on the scope of their intra-state activities (eg, opening an office, hiring employees, etc), entities may be required to register to do business in one or more US states.

2.9 Rules Concerning Service Providers

Broad Discretion to Appoint Service Providers

Under relevant federal law, alternative funds and their managers have discretion to appoint service providers.

Custodians – SEC Custody Rule

Under the Advisers Act, where a SEC-registered investment adviser (RIA) is deemed to have "custody" of a fund's assets, the adviser becomes subject to Rule 206(4)-2 of the Advisers Act, more commonly known as the custody rule (the "Custody Rule"), which, among other things, requires the adviser to place the fund's securities with custodians who meet the definition of "qualified custodian" unless it delivers audited annual financial statements of the fund to its investors.

2.10 Anticipated Changes

On 26 October 2022, the SEC proposed Rule 206(4)-11 under the Advisers Act that would prohibit RIAs from outsourcing certain "covered functions" without meeting the requirements set forth in the rule. If adopted, the proposed rule would introduce four main requirements for RIAs: due diligence and monitoring; books and records; oversight of service providers serving as recordkeepers; and changes to Form ADV.

On 15 February 2023, the SEC issued a proposed rule that would replace the Custody Rule with Rule 223-1 regarding the safeguarding of client assets (the "Safeguarding Rule"). Beyond a change in nomenclature, the proposed Safeguarding Rule would greatly expand the scope of RIAs' responsibilities and duties to their clients, including private funds. Like the Custody Rule, the proposed Safeguarding Rule would not apply to exempt reporting advisers.

3. Fund Managers

3.1 Origin of Promoters/Sponsors of Alternative Funds

US alternative funds are predominantly established by US promoters and sponsors. Non-US advisers may also establish US funds for various purposes. In order to avoid integration of their US investment advisory activities with their global business operations, some non-US investment advisers may form separate US-affiliated investment advisers.

3.2 Legal Structures Used by Managers

See Section **3.4 Tax Regime for Managers**.

3.3 Regulatory Regime for Managers

Registration Under the Advisers Act

Section 202(a)(11) of the Advisers Act defines an "investment adviser" to mean: "any person who, for compensation, engages in the business of advising others… as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

An adviser that falls within the definition of "investment adviser" under the Advisers Act may have to register under the Advisers Act and be subject to its substantive requirements, unless an exemption applies (with respect to the registration requirements for investment advisers under the Advisers Act, see **2.3 Disclosure/Reporting Requirements**).

Exemptions from Registration under the Advisers Act. The exemptions from registration as an investment adviser under the Advisers Act are as follows:

- The private fund adviser exemption applies to advisers who solely manage private funds with less than USD150 million in assets under management in the United States.
- The venture capital fund adviser exemption applies to advisers who advise solely venture capital funds.
- The foreign private adviser exemption applies to non-US advisers with limited US client and investor bases (ie, less than USD25 million in assets under management from US clients and investors, and fewer than 15 such clients and investors).

Fiduciary Duties and Anti-fraud Protections

An investment adviser (whether registered or unregistered) is a fiduciary with respect to all its clients. Advisers owe duties of loyalty and good faith to clients, and must act in accordance with those duties, including by providing full and fair disclosure of all material facts to current and prospective investors, and an affirmative duty to use reasonable care to avoid misleading clients.

Section 206 of the Advisers Act contains broad "anti-fraud" provisions that make it unlawful for an investment adviser to directly or indirectly engage in the following:

- devices, schemes or artifices to defraud any client or prospective client;
- transactions that operate as a fraud or deceit upon any client or prospective client;
- when acting as principal for its own account, knowingly selling any security to or purchasing any security from a client for its own account, without disclosing to the client in writing the capacity in which it (or an affiliate) is acting and obtaining the client's consent before the completion of the transaction; and
- any act, practice or course of business that is fraudulent, deceptive or manipulative.

Commodity Exchange Act

Registration requirements

As discussed above, if a fund invests in any amount of Commodity Interests, directly or indirectly, the fund will fall within the definition of a "commodity pool". The operator (ie, sponsor or general partner) and the investment manager of a commodity pool must be registered with the CFTC as a CPO and must become a member of the NFA unless it can avail itself of an exemption.

Many managers that only invest in Commodity Interests on a limited basis rely on an exemption from registration as a CPO found in CFTC Regulation 4.13(a)(3). Rule 4.13(a)(3) provides an exemption for managers that operate pools that restrict participation to accredited investors, certain family trusts formed by accredited investors and "knowledgeable employees" and either (i) the aggregate net notional value of the fund's commodity interest positions does not exceed 100% of the liquidation value of its portfolio, or (ii) the aggregate initial futures margin and options premium needed to establish the fund's commodity interest positions does not exceed 5% of the liquidation value of its portfolio. The investment manager to a fund satisfying these requirements does not have to register as a CTA.

CFTC Rule 4.14(a)(10), together with Section 4m(l) of the CEA, exempts any person from the requirement to register as a CTA, provided that such person has not during the prior 12 months furnished commodity trading advice to more than 15 persons and such person does not hold itself out generally to the public as a CTA. The CFTC rules that an adviser with its principal place of business outside the USA need only count US-based clients for purposes of such 15-client limitation. In order to rely on the "de minimis" exemption, no regulatory filing or approval is necessary.

CFTC regulations require all commodity pools sponsored by registered CPOs to have a "disclosure document" (ie, a private placement memorandum) that contains certain disclosures prescribed by regulation and which must be reviewed by the NFA, unless an exemption from such requirement is available.

If a CPO limits the investors in a fund solely to "qualified eligible persons" (QEPs) as defined in CFTC Rule 4.7, the CPO is exempt from the requirement that its pool have a disclosure document reviewed by the NFA, nor must any voluntary disclosure document contain required CFTC disclosures other than a required disclaimer (although the document must contain all relevant information and disclosures so as not to make the document materially misleading).

Generally, QEPs are accredited investors that meet a portfolio requirement (either USD2 million in securities or USD200,000 in futures margin or options on futures premium, or some proportional combination of the foregoing (although not effective at the time of this publication, the CFTC increased these amounts to USD4 million and USD400,000, respectively)). Qualified purchasers, "knowledgeable employees", certain regulated entities or investment professionals, as well as non-US investors generally, are also deemed to be QEPs.

US Securities Exchange Act of 1934 (the "Exchange Act")

Section 15(a) of the Exchange Act provides that it is unlawful for any broker or dealer to make use of any means of interstate commerce in the United States to effect any transactions in, or induce the purchase or sale of, any security, unless it is registered with the SEC or an exemption from registration is available. Generally, a broker is a person engaged in the business of effecting transactions in securities for the account of others for a commission, and a dealer is a person engaged in the business of buying and selling securities for such person's own account through a broker or otherwise. For the most part, an issuer of securities (such as a fund) should not be deemed to be a dealer since it is not both buying and selling its securities. Furthermore, an issuer (such as a fund) should not be considered a broker because the securities it is selling are not being sold for the "account of others"; rather, they are being sold by the issuer for its own account.

Unlike an issuer, an issuer's employee or its general partner's employees may be deemed to be selling securities for the account of others for a commission. See **4.5. Compensation and Placement Agents**.

Rule 10b-5 under the Exchange Act provides for liability for any material misstatement or omission in connection with the purchase or sale of a security involving the use of US jurisdictional means.

3.4 Tax Regime for Managers

Tax Considerations for US Managers

Fund managers are generally formed as limited partnerships or LLCs and are pass-through entities for US federal income tax purposes. As such, these entities are not subject to entity-level federal income taxes but are subject to the special carried interest rules discussed under **3.6 Taxation of Carried Interest**. If a US manager is formed as a limited partnership, a separate entity is generally formed to act as the general partner of such limited partnership. Additionally, US fund managers often utilise two entities: a "management company" to receive the management fee, and the general partner of the fund to receive the carry. This has several benefits for US managers, including providing flexibility as to who participates in the economics of each entity as well as minimising state tax consequences to the principals. The management company itself is typically set up either as a single limited partnership or LLC, a single S corporation, or with a two-tier structure (with an LLC on top of a limited partnership). Various tax considerations (including US self-employment tax considerations) affect which structure should be used by any given fund.

Tax Considerations for Non-US Managers

Whether a non-US manager will be subject to US federal income tax will depend on whether the manager is engaged in a trade or business in the United States. Whether a manager is engaged in a trade or business in the United States is heavily dependent on the applicable facts and circumstances, but two important factors in such determination are whether the activities conducted in the United States are essential and directly related to the production of income, and whether the manager has a physical presence, such as an office or employees, in the United States. A non-US fund manager may find it beneficial to form a US subsidiary that is taxed as a corporation for US federal income tax purposes to conduct managerial activities in the United States, rather than exposing the non-US fund manager itself to any US federal income tax liability or reporting obligations.

3.5 Rules Concerning Permanent Establishments

If a fund has a US-based general partner or investment manager, such general partner or investment manager's US presence should generally not cause a non-US fund or a non-US investor in a fund to be subject to US federal income tax as long as the activities of the fund consist predominately of passively investing in securities.

However, if a fund acts as a dealer in securities, the fund will be deemed to generate ECI for its non-US investors and UBTI for its US tax-exempt investors if such dealing activities occur in the United States. Additionally, activities, such as loan origination and investing in real estate and certain so-called "US real property holding corporations" can also be expected to generate ECI and UBTI for non-US investors.

3.6 Taxation of Carried Interest

Carried interest is a tax-efficient way to compensate principals of the general partner of the fund. Carried interest reflects a right to future undetermined profits of the fund above a certain performance threshold, and accordingly is not taxable upon grant by the general partner of the fund. Furthermore, carried interest allocations are not taxed as compensation. Instead, the character (as ordinary income, short-term capital gain or long-term capital gain) of amounts allocated with respect to carried interest is the same as it was when recognised by the partnership, except that long-term capital gain recognised by a partnership on the sale of an asset held for not more than three years is treated as short-term capital gain (which, as at the time of publication, is taxed at the same rate as ordinary income) when allocated to a non-corporate holder of carried interest. In addition, capital gain recognised by a carried-interest holder on the sale of its carried interest is treated as short-term capital gain, rather than long-term capital gain if the carried interest was not held for more than three years prior to being sold.

3.7 Outsourcing of Investment Functions/Business Operations

Managers are permitted to outsource a substantial portion of their investment functions or business operations. Managers remain responsible for ensuring effective compliance with their regulatory obligations, even with respect to outsourced services. See **2.9 Rules Concerning Service Providers**.

3.8 Local Substance Requirements

See **2.8 Local/Presence Requirements for Funds**.

RIAs, CPOs and CTAs managing alternative funds are not subject to any regulatory capital requirements or other local substance requirements under applicable federal law and related SEC, CFTC and/or NFA rules (as applicable).

3.9 Change of Control

Section 205(a)(2) of the Advisers Act generally makes it unlawful for an RIA to enter into or perform any investment advisory contract unless the contract provides that no assignment of the contract shall be made by the adviser without client consent. For these purposes, an assignment includes any direct or indirect transfer or hypothecation (ie, pledging) of an advisory contract and any direct or indirect change in control of an RIA.

3.10 AI and Use of Data

In July 2023, the SEC proposed new rules that would require RIAs to, among other things, eliminate/neutralise conflicts of interest that result in placing the firm's interests ahead of investors' interests when using "covered technology" (eg, algorithms and artificial intelligence) in investor interactions.

3.11 Anticipated Changes

See **3.10. AI and Use of Data** regarding proposed new SEC rules to address conflicts of interest associated with the use of predictive data analytics by investment advisers.

4. Investors

4.1 Types of Investors in Alternative Funds

Investment advisers generally structure their funds in a manner to accommodate various categories of investors. Common categories of investors include US government plans, corporate benefit plans, financial institutions, sovereign wealth funds, family offices, university and charitable endowments and high net worth individuals. Investments in funds are often structured to accommodate the tax and other legal and regulatory needs of certain investors.

4.2 Side Letters

There are currently no express restrictions under the US federal securities laws that would restrict the use of side letters. Under the SEC's recently vacated Preferential Treatment Rule (under the Private Fund Adviser Rules defined below), private fund advisers would have been prohibited from providing certain preferential terms to investors regarding redemption rights and portfolio transparency preferences, where the adviser reasonably expects such preference could have a material negative effect on other investors in the private fund. However, in June 2024, the United States Court of Appeals for the Fifth Circuit vacated the Private Fund Adviser Rules and the SEC did not appeal the ruling.

4.3 Marketing of Alternative Funds to Investors

See **2.2 Regulatory Regime for Funds** and **3.3 Regulatory Regime for Managers** for descriptions of the applicable investor qualification standards under the Securities Act, Investment Company Act, Advisers Act and CEA.

4.4 Rules Concerning Marketing of Alternative Funds

No General Advertising or Solicitation

As highlighted in **2.3 Regulatory Regime for Funds** and **3.3 Regulatory Regime for Managers**, alternative funds typically offer interests to US investors in Rule 506(b) offerings and thus may not engage in general solicitation or general advertising in connection with the offering.

"Bad actor" Disqualification

The SEC has adopted certain "bad actor" disqualification provisions for Rule 506 of Regulation D under the Securities Act. As a result of the Rule 506(d) bad actor disqualification, an offering of securities is disqualified from relying on Rule 506(b) and 506(c) of Regulation D if the issuer or any other person covered by Rule 506(d) has a relevant criminal conviction, regulatory or court order or other "disqualifying event".

The final rule provides an exception from disqualification when the issuer is able to demonstrate that it did not know and, in the exercise of reasonable care, could not have known that a covered person with a disqualifying event participated in the offering. The steps an issuer should take to exercise reasonable care will vary depending on particular facts and circumstances.

SEC's Marketing Rule

The SEC's Marketing Rule (effective as of November 2022) applies to RIAs and was established to modernise rules governing advertisements and payments to solicitors and to comprehensively regulate marketing communications.

As defined under the Marketing Rule, an "advertisement" includes any direct or indirect communication an investment adviser makes that: (i) offers advisory services with regard to securities to prospective clients or private fund investors, or (ii) offers new investment advisory services with regard to securities to current clients or private fund investors. The first prong of the definition excludes most one-on-one communications and contains certain other exclusions. The definition also generally includes any endorsement or testimonial for which an adviser provides cash and non-cash compensation directly or indirectly (eg, directed brokerage, awards or other prizes, and reduced advisory fees).

The Marketing Rule generally prohibits:

- making untrue statements of a material fact (or omissions thereof);
- making material statements of fact without a reasonable basis (or the ability to substantiate such statements upon demand by the SEC);
- discussing potential benefits without providing fair and balanced treatment of associated material risks or limitations;
- referencing specific investment advice provided by the adviser that is not presented in a fair and balanced manner;
- including or excluding performance results, or presenting performance time periods, in a manner that is not fair and balanced; and
- including information that is otherwise materially misleading.

The Marketing Rule also prohibits the use of testimonials and endorsements in an advertisement, unless the adviser satisfies certain disclosure, oversight, and disqualification provisions, including:

- clear and prominent disclosure whether the person giving the testimonial or endorsement (the "promoter") is a client or is being compensated (together with additional disclosures regarding compensation and conflicts of interest); and
- adviser compliance and oversight of such testimonial or endorsement's compliance with the marketing rule.

The rule prohibits the use of third-party ratings in an advertisement, unless the adviser provides disclosures and satisfies certain criteria pertaining to the preparation of the rating.

Finally, the rule prohibits including in any advertisement:

- gross performance, unless the advertisement also presents net performance;
- any statement that the SEC has approved or reviewed any calculation or presentation of performance results;
- performance results from fewer than all portfolios with substantially similar investment policies, objectives, and strategies as those being offered in the advertisement, with limited exceptions;
- performance results of a subset of investments extracted from a portfolio, unless the

advertisement provides, or offers to provide promptly, the performance results of the total portfolio;
- hypothetical performance (which does not include performance generated by interactive analysis tools), unless the adviser adopts and implements policies and procedures reasonably designed to determine that the performance is relevant to the likely financial situation and investment objectives of the intended audience and the adviser provides certain information underlying the hypothetical performance; and
- predecessor performance, unless there is appropriate similarity with regard to the personnel and accounts at the predecessor adviser and the personnel and accounts at the advertising adviser; in addition, the advertising adviser must include all relevant disclosures clearly and prominently in the advertisement.

Marketing to US State and Local Government Entity Investors

Rule 206(4)-5 under the Advisers Act (the "Pay to Play Rule") is generally designed to address pay-to-play abuses involving campaign contributions made by certain investment advisers or their covered associates to government officials who are in a position to influence the selection of investment advisers to manage government client assets, including the assets of public pension funds and other public entities. Among other things, Rule 206(4)-5 prohibits certain investment advisers from providing investment advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees makes a campaign contribution to certain elected officials or candidates who can influence the selection of certain investment advisers.

In soliciting investments from any US state or local government entities, investment advisers should consider any applicable US state or local lobbying rules that may apply.

4.5 Compensation and Placement Agents

Many funds (in particular, private equity funds) will use placement agents to market and sell interests. Generally, entities that are engaged in brokering the purchase or sale of securities for issuers are required to register as broker-dealers under the Exchange Act. All arrangements with placement agents must also comply with the Marketing Rule regarding testimonials and endorsements (see **4.4 Rules Concerning Marketing of Alternative Funds**).

In addition, the manner in which an investment adviser compensates its employees in connection with US sales and marketing activities can raise broker-dealer concerns. Determining whether a person is a broker-dealer can be fact intensive. One of the most frequently considered factors when determining if employees are acting as unregistered brokers is whether they receive compensation directly or indirectly related to, or based on, transactions in securities of the fund or its portfolio companies.

Exchange Act Rule 3a4-1 generally provides that an associated person (or employee) of an issuer who participates in the sale of the issuer's securities would not have to register as a broker-dealer if that person at the time of participation:

- is not subject to a "statutory disqualification," as defined in Section 3(a)(39) of the Exchange Act;
- is not compensated by payment of commissions or other remuneration based directly or indirectly on securities transactions;

- is not an associated person of a broker or dealer; and
- limits its sales activities as set forth in the rule.

4.6 Tax Regime for Investors

US federal and state tax consequences depend on the jurisdiction and the tax status of each particular investor in a fund.

US Tax-Exempt Investors

US tax-exempt investors, such as charitable organisations, pension funds, private foundations and individual retirement accounts, are generally exempt from US federal income taxation except to the extent that they earn UBTI, which can arise when a fund that is a pass-through entity for US federal income tax purposes borrows money to fund its investments. In addition, UBTI can arise if a fund is itself engaged in a US trade or business or invests in pass-through portfolio companies conducting a US trade or business. Blocker structures or parallel funds can be utilised to minimise UBTI for US tax-exempt investors.

US Taxable Investors

A typical US non-corporate investor is subject to US federal income tax at a maximum rate of 37% plus an additional 3.8% tax applicable to the investor's net investment income. A typical US corporate investor is subject to US federal income tax at a rate of 21%. Various limitations may apply to a US non-corporate investor's ability to deduct certain losses and expenses. Some of these limitations may depend on the activities of the fund. A US corporate investor is typically not subject to such limitations.

Non-US Investors

Withholding tax

US withholding taxes of 30% generally apply to certain types of non-business income (typically, US-source dividends and certain dividend equivalent income, and limited types of US-source interest income – commonly referred to as Fixed, Determinable, Annual, or Periodical, or "FDAP" income) allocable by a US fund to non-US investors. Certain exemptions or reductions in tax rate may be available under applicable tax treaties. Foreign governments and sovereign wealth funds are not subject to US withholding tax on certain types of US-source income, including dividends and interest. Capital gain income is also not generally subject to US income or withholding tax unless it is attributable to investments in US real property interests.

Income tax

Non-US investors can also be subject to US federal income tax on income and gains that are ECI. For example, loan origination by a fund may be treated as generating ECI, which would require a non-US investor to pay US federal income tax and file a US income tax return. Domestic funds with non-US investors are required to make quarterly tax payments to the IRS on account of ECI allocable to non-US investors and must withhold US tax from redemption payments to the extent attributable to ECI-generating investments. Additionally, non-US investors may be required to file tax returns and pay taxes in US states where the fund generates ECI.

4.7 Double Tax Treaties

Utilisation by Investors

Non-US investors in funds may be able to claim tax treaty benefits (typically, a reduction in or complete exemption from 30% US withholding tax described above) under an income tax treaty between their jurisdiction of residence and the United States. In order to establish eligibility to claim tax treaty benefits, a non-US investor should claim such benefits on an applicable IRS Form W-8 provided to the fund.

Structuring Issues

Certain jurisdictions, such as Germany and the United Kingdom, may limit the availability of tax treaty benefits to a resident of those jurisdictions that invests in a fund organised as an LLC rather than as a limited partnership. For this reason, US funds that are targeting non-US investors may choose to be organised as limited partnerships rather than as LLCs.

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

Under FATCA, US funds are generally required to collect and remit a 30% US withholding tax on their payments of US-source dividends and interest to a non-US "foreign financial institution" or "non-financial foreign entity" (each as defined) unless such non-US person makes certain certifications or provides certain information relating to its US owners or qualifies for exemption from FATCA.

Typically, a US fund will obtain an appropriate IRS Form W-8 from its foreign investors that will include the requisite FATCA certifications. Different rules may apply to foreign financial institutions located in jurisdictions that have an intergovernmental agreement with the United States governing FATCA.

4.9 Anti-Money Laundering (AML) and Know Your Customer (KYC) Regime

During regulatory examinations, the SEC staff will typically request information from investment advisers regarding AML compliance policies and procedures. Information requested frequently includes the identity of private fund investors.

On 28 August 2024, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) published a rule that imposes certain anti-money laundering and combating the financing of terrorism programme and other Bank Secrecy Act-related obligations on most private fund managers, including RIAs and "exempt reporting advisers", effective 1 January 2026. The final rule responds to public comments by adopting a narrower definition of "investment adviser" than initially proposed in February 2024, and excludes from the definition: RIAs that register with the SEC solely because they are (i) mid-sized advisers; (ii) multi-state advisers; or (iii) pension consultants; as well as RIAs that are not required to report any AUM to the SEC on Form ADV.

The final rule also addresses comments relating to how the proposed rule would apply to RIAs or ERAs that have a principal office and place of business outside the United States. For these investment advisers (defined as "foreign-located investment advisers" in the final rule), the final rule only applies to their advisory activities that (i) take place within the United States, including through the involvement of US personnel of the investment adviser or (ii) provide advisory services to a US person or a foreign-located private fund with an investor that is a US person.

4.10 Data Security and Privacy for Investors

Regulation S-P requires RIAs and their funds to adopt written policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. This includes protecting against any anticipated threats or hazards to the security or integrity of customer records and information and against unauthorised access to or use of customer records or information. The rule also requires firms to provide initial and annual privacy notices to customers describing information sharing policies and informing customers of their rights.

4.11 Anticipated Changes

On 15 May 2024, the SEC adopted amendments to Regulation S-P, the regulation that governs the treatment of non-public personal information about consumers by certain financial institutions. The amendments apply to RIAs and are designed to modernise and enhance the protection of consumer financial information.

On 9 February 2022, the SEC proposed additional rules and amendments to ensure that RIAs maintain more robust cybersecurity policies. The proposed rules and amendments primarily include the following: (i) proposed Rule 206(4)-9 under the Advisers Act, which would require RIAs to address cybersecurity risks in their policies and procedures; (ii) proposed Rule 204-6 under the Advisers Act, which would require RIAs to report all material cybersecurity incidents to the SEC by submitting a new Form ADV-C; and (iii) requiring RIAs to include cybersecurity incidents in Part 2A of their Form ADVs.

Trends and Developments

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Winston & Strawn

Winston & Strawn has served as a trusted adviser and advocate for clients across virtually every industry for more than 170 years. Its national funds practice advises private fund sponsors, alternative asset managers, funds of funds, pension plans, family offices, and institutional investors on all aspects of their fund formation transactions. The practice also addresses special situations, sponsor separations, fund restructurings and other GP-led secondary transactions. The practice is also among the most active in LP secondaries transactions by volume, representing both buyers and sellers on secondary transactions, as well as lead and syndicate LPs on their investments in continuation funds, tender offers, and other GP-led secondaries transactions. Winston & Strawn also has the nation's leading SBIC practice, the largest by market share, advising on 60-70% of the USD41 billion annual programme, reflecting consistent growth and prominence in the sector. The firm's transactional capabilities are supported by its financial services, regulatory, tax, and compliance capabilities, including SEC regulatory and compliance issues and SEC examinations.

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Continuation Funds Rising

GP-led secondaries have become a mainstay of the private funds landscape, and their prominence continues to expand. Over the past decade, these transactions have become a well-established mechanism for offering liquidity solutions to general partners and investors. The typical continuation fund transaction (although one should expect a fair degree of customisation in any such process) will often include the following features:

- a new "continuation vehicle" (CV) being formed by the sponsor, which is capitalised by new limited partners (ie, who will invest as new limited partners in the CV);
- new investors are typically secondary funds or sophisticated institutional investors; one or more lead investors will typically lead the investment in the CV (and negotiate terms with the sponsor);
- involves a GP-organised process to proactively offer liquidity to existing limited partners and to secure additional time and/or capital for all or select fund investments;
- election process: current fund limited partners are typically offered the opportunity to elect to cash out of the existing fund (a "cashout" option) or roll over their interests (a "rollover" option) into the new CV; and
- depending on the structure and terms, current fund limited partners may be offered a "status quo" option (in which they roll over to the CV on the same economic terms).

Because these transactions include the sale of one or more portfolio assets among affiliated entities controlled by the same adviser (or affiliated advisers), conflicts of interest should be disclosed and appropriately approved (often by the fund's limited partner advisory board) as part of the transaction process. Moreover, as a general matter it will be important for a fund general partner to show a full and fair process by which pricing was achieved, often involving hiring a financial adviser to lead a secondary process. Typically, a fairness opinion or valuation report will be obtained in connection with the transaction (along with disclosure of any conflicts involved with respect to an institution issuing such fairness opinion or valuation report).

Overall, these transactions have become an excellent way to achieve liquidity for investors in both single- and multi-asset sale transactions. When done right, these transactions facilitate price maximisation through an arm's length auction process and provide investors with an option to achieve liquidity or maintain their existing stake.

Moreover, these transactions allow fund general partners to pursue liquidity options even where the market for underlying portfolio assets may not be ideal or where they need more time to achieve optimal value. The continuation fund is a vehicle through which a fund sponsor can:

- raise additional follow-on capital;
- extend the window of time that it has to maximise the underlying value of portfolio assets;
- secure new fees and carried interest (at a reset net asset value) in order to better align the incentives of the investment team with investors;
- introduce new investors to the platform with the potential to provide additional financing support for future fundraises; and
- provide new investors with exposure to a concentrated portfolio which they are able to diligence (as opposed to a blind pool).

These transactions are highly bespoke. Sponsors seeking to pursue liquidity options through continuation vehicles should consult their legal counsel to ensure that the transactions are being structured in a manner that:

- comports with market terms;
- maximises value and utilises an optimal structure for tax and other legal purposes;
- complies with all U.S. Securities and Exchange Commission guidance and rules; and
- demonstrates overall fairness to existing fund investors.

SBIC Programme

As the fundraising market has tightened, there has been a significant increase in the number of venture capital and private equity funds applying to operate as a small business investment company (SBIC). SBICs are licensed and regulated by the U.S. Small Business Administration (SBA) and subject to the Small Business Investment Act of 1958, as amended, and the rules and regulations promulgated thereunder (the "SBIC Act"). Most licensed SBIC funds apply for SBA funding, known as leverage, as they believe the receipt of SBA funding will enhance their operations and returns, and that the benefits associated with becoming an SBIC far outweigh the risks and regulatory oversight and constraints.

Description of the SBIC programme

The SBIC programme was created by Congress in 1958. SBICs are privately organised and privately managed profit-motivated investment firms licensed by the SBA that, with their own capital and with funds obtained through the federal government, provide capital to small independent businesses, both new and already established.

Types of SBICs

There are four types of SBICs: (i) leveraged regular debenture fund; (ii) accrual debenture fund; (iii) reinvestor fund; and (iv) unleveraged fund. Currently, the amount of debentures (regular or accrual) outstanding from a single SBIC cannot exceed USD175 million, and the amount outstanding from a group of commonly managed SBICs cannot exceed USD350 million.

Leveraged regular debenture fund

A leveraged regular debenture SBIC receives funding from the SBA in the form of debentures. Each debenture received by the SBIC has a ten-year maturity and is not amortised prior to maturity. Interest is paid semi-annually. The interest rate is established when the debentures are issued and is calculated based on a market-driven spread above the ten-year U.S. Treasury rate. Debentures are unsecured, and no personal guarantees are required. Prepayments of the debentures can be made without penalty. Most regular debenture SBICs execute a debt-oriented strategy in later-stage companies that can pay regular interest, although a minority of regular debenture funds are control and buyout focused.

Accrual debenture fund

Funds receiving an accrual debenture license receive funding from the SBA in the form of accrual debentures. Unlike the regular debenture programme, accrual debentures accrue interest over a ten-year term and the interest is reserved by the SBA as part of the leverage issuance. Similar to the regular debentures, the accrual debentures are unsecured and the interest rate is established when the debentures are issued and calculated based on a market-driven spread above the ten-year U.S. Treasury rate. Principal can be prepaid without penalty any time following the two-year anniversary of the settlement date of the accrual debenture. All outstanding interest and annual fees must be paid before principal repayments of the accrual debentures can be made. Funds that have applied to be an accrual debenture SBIC are generally venture capital, growth equity or buyout-oriented where the regular payment of interest by the portfolio companies is not required.

Reinvestor SBIC fund

A fund receiving a reinvestor SBIC license receives funding from the SBA in the form of accrual debentures, and the reinvestor SBIC is required to invest a majority of its capital (private and SBA leverage) in underserved fund managers. Those underserved fund managers must in turn invest in SBIC compliant transactions.

Unleveraged SBIC fund

A fund receiving an unleveraged SBIC license receives no funding from the SBA. Funds that apply to the SBA for an unleveraged license do so to attract financial institutions as investors. Certain financial institutions may invest in SBICs where they otherwise may be prohibited from investing in other similar vehicles due to a financial institution's limitations on private equity investments pursuant to the "Volcker Rule" of the Dodd Frank Wall Street Reform and Consumer Protection Act.

Licensing

A proposed SBIC fund must file a comprehensive license application (which includes legal documents) with the SBA. During the licensing process, the SBA reviews the applicant's business plan, projections and legal documents and conducts reference and other background checks on the management team. At the conclusion of the licensing process, a successful applicant is issued a "green light" letter, which certifies that the management team will be issued an SBIC license when the SBA approves final legal documentation, evidence of sufficient investor subscriptions and there have been no adverse changes to the applicant.

Restrictions on SBIC investments

All SBICs must follow certain guidelines with respect to their investments in order to be deemed in good standing and remain eligible for SBA leverage. These guidelines include but, are not limited to:

- Restrictions as to the size and types of businesses in which the SBIC may invest: An SBIC may only invest in small businesses which include those entities (i) with a tangible net worth not in excess of USD24,000,000 and an average net income after US federal income taxes (excluding any carry-over losses) for the preceding two completed fiscal years not in excess of USD8,000,000, as may be adjusted from time to time; or (ii) which meet the size standard as established in SBA regulations based on the North America Industry Classification System (NAICS) tables.
- Smaller enterprise investment requirement: An SBIC must invest at least 25% of its invested funds in "Smaller Enterprises". Smaller Enterprises include those entities (i) with tangible net worth not in excess of USD6,000,000 and an average net income after federal income taxes (excluding any carry-over losses) for the preceding two completed fiscal years not in excess of USD2,000,000, or (ii) which meet the size standard as established in SBA regulations based on the NAICS tables.
- The avoidance of conflict-of-interest issues: An SBIC may not engage in self-dealing to the advantage of its associates.
- Overline limitations: Without written SBA approval, a leveraged SBIC may not invest

more than 10% of its private capital commitments and anticipated SBA leverage in a single portfolio company and its affiliates. This limitation does not apply to unleveraged SBIC funds.
- Minimum and maximum period of financing requirements: Generally, the duration of all financings must be for a minimum period of one year and no longer than 20 years.
- There are limits on interest and fees chargeable to portfolio companies.

Additionally, SBA regulations generally preclude investments in the following types of businesses: (i) other SBICs (except that a reinvestor SBIC may invest in an unleveraged SBIC); (ii) finance and investment companies or finance-type leasing companies; (iii) unimproved real estate; (iv) companies with less than one-half of their assets and employees in the USA; (v) with certain exceptions, passive businesses; (vi) companies that will use the proceeds to acquire farmland; (vii) cemetery subdividers or developers; and (viii) with certain exceptions, investments that are purchased other than from an issuer. An SBIC may not be a general partner of a partnership.

Operational requirements

There are a number of regulations intended to assure an SBIC's proper management and operations. If a leveraged SBIC defaults on its payment obligations under the SBA debentures, fails to comply with the applicable SBIC regulations or is otherwise found to be in violation of the SBIC Act, the SBA has a series of remedies that it may impose, including the right to accelerate the maturity of all amounts due under its debentures. Additionally, in such instances, the SBA can remove the general partner of an SBIC, bring suit for the appointment of a receiver for an SBIC and for its liquidation.

Financial institution investment and Community Reinvestment Act

One advantage of being an SBIC is the ability to have financial institutions as investors. Generally, financial institutions are precluded from investing in private equity and venture capital funds. Further, an investment by a financial institution in an SBIC (leveraged or unleveraged) whose regional focus includes the financial institution's Community Reinvestment Act (CRA) assessment area is specifically identified as a type of investment that will be presumed by the regulatory agencies to promote economic development and meet the standards of a "Qualified Investment" for CRA purposes. Thus, an investment in an SBIC by a regulated financial institution is eligible for full credit under CRA, with full credit being defined as 100% of the dollar amount of the investment in the SBIC.

US Regulatory Trends

The regulatory landscape for private funds continues to grow more complex, with new rules and regulations adopted and proposed by the U.S. Securities and Exchange Commission (SEC) and various other regulatory authorities. The following are some highlights of court actions, new or proposed rules and regulatory initiatives.

Courts

Private fund rules vacated

One welcome relief came on 5 June 2024, when the United States Court of Appeals for the Fifth Circuit invalidated five regulations and related amendments under the U.S. Investment Advisers Act of 1940 (the "Advisers Act") known as the Private Fund Adviser Rules (PFAR or "Private Fund Rules"). In August 2023, the SEC adopted PFAR to oversee the conduct of investment advisers to private funds. Even though the Private Fund Rules have been vacated, and the SEC has determined not to appeal the ruling to the United States Supreme Court, the Private Fund Rules provide valuable insight into the thinking of the staff at the SEC. As such, regardless of whether the SEC appeals the ruling, the SEC may attempt either to re-propose similar rules or guide conduct through examination and enforcement. Generally, the primary Private Fund Rules were:

- Rule 206(4)-10 (the "Private Fund Audit Rule"): This rule would have required private fund advisers registered with the SEC ("RIAs") under the Advisers Act to deliver audited financial statements to the investors of each private fund they manage within 120 days of each fiscal year-end.
- Rule 211(h)(1)-2 (the "Quarterly Statements Rule"): This rule would have required RIAs to provide investors with quarterly statements that included performance statistics, fees and expenses paid by the private fund, the costs of investing in the private fund, and compensation and other amounts paid to the adviser.
- Rule 211(h)(2)-2 (the "Adviser-Led Secondaries Rule"): This rule would have required RIAs to obtain a fairness or valuation opinion when offering investors the option to sell or convert their interests in a private fund to those in another vehicle managed by the adviser or its affiliates and to provide detailed disclosures to investors of any material business relationship the adviser had with the party providing the opinion.
- Rule 211(h)(2)-1 (the "Restricted Activities Rule"): This rule would have restricted certain activities by private fund advisers, including charging specific fees and expenses to the fund without investor approval and borrowing or receiving extensions of credit from a private fund without investor approval.
- Rule 211(h)(2)-3 (the "Preferential Treatment Rule"): This rule would have prohibited private fund advisers from providing preferential terms to certain investors if it would be detrimental to other investors and required disclosure of any preferential treatment given to some investors to all other investors within the private fund.

Chevron deference no more

For the last 40 years, based on "Chevron deference", federal administrative agencies have won over 90% of the lawsuits filed against them by private plaintiffs seeking to set aside final agency regulations or final agency orders. In 2024, the regulatory landscape changed dramatically when the Supreme Court of the United States in Loper Bright Enterprises v. Raimondo abandoned the Chevron deference doctrine. Now, federal courts must interpret ambiguous federal statutory language without being required to accept an agency's interpretation. This change in interpretative methodology is expected to frustrate federal financial agencies in their attempts to make policy and embolden regulated financial firms, including private fund managers, to challenge agency action.

Certain new rules

Beneficial ownership reporting

Beginning January 2024, private fund managers must now consider the potential reporting and structural implications that result from the Corporate Transparency Act (CTA), and the regulations implementing the beneficial ownership information (BOI) reporting requirements of the CTA (for simplicity, the CTA and the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN)'s implementing regulations are collectively referred to as the "BOI Reporting Rule"). Among other things, private fund managers must now analyse whether certain reporting obligations apply to entities within their fund structure and whether it is feasible to consider structural changes to simplify or minimise reporting obligations under the BOI Reporting Rule.

SEC adopts rules elaborating on the "dealer" definition

On 6 February 2024, the SEC adopted new Rules 3a5-4 and 3a44-2 (collectively, the "New Dealer Rules"), which expand the definition of a "dealer" and "government securities dealer" under the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act"). In short, the final rules require market participants that take on significant liquidity-providing roles to register with the SEC, become members of a self-regulatory organisation, and comply with federal securities laws and regulatory obligations. Hedge funds are more likely to meet the New Dealer Rules' definition of dealing, while private equity funds are less likely.

U.S. Department of Labor publishes final amendment to the QPAM exemption

On 3 April 2024, the U.S. Department of Labor (DOL) published its final amendment (the "QPAM Amendment") to Prohibited Transaction Class Exemption 84-14 (the "QPAM Exemption"). The QPAM Exemption is heavily relied on by investment professionals who manage the assets of certain employee benefit plans subject to the U.S. Employee Retirement Income Security Act of 1974, as amended, plans and accounts subject to Section 4975 of the U.S. Internal Revenue Code and private funds that are treated as plan asset vehicles (collectively, "Benefit Plans"). A "QPAM" includes an RIA that (i) meets specified asset and equity thresholds under the QPAM Exemption, and (ii) exercises discretionary authority over Benefit Plan assets. Among many changes to the QPAM Exemption, the QPAM Amendment increased assets under management and equity thresholds required for QPAM status, requires a filing with the DOL, imposes a ten-year disqualification for criminal convictions and "prohibited misconduct", and requires record-keeping of compliance with the QPAM exemption.

Amendments to Regulation S-P

On 15 May 2024, the SEC adopted amendments to Regulation S-P under the Advisers Act, the regulation that governs the treatment of non-public personal information about consumers by certain financial institutions, including RIAs. The amendments to Regulation S-P generally (i) require RIAs to develop and maintain written policies and procedures for an incident response programme that is reasonably designed to detect, respond to, and recover from unauthorised access to or use of customer information; (ii) require that the response programme include procedures for RIAs to provide timely notification to affected individuals; and (iii) broaden the scope of information covered by Regulation S-P's requirements.

AML/CFT compliance obligations

On 28 August 2024, FinCEN published a rule that imposes certain anti-money laundering and combating the financing of terrorism programme and other Bank Secrecy Act-related obligations on most private fund managers, including RIAs and "exempt reporting advisers", effective 1 January 2026. The final rule responds to public comments by adopting a narrower definition of "investment adviser" than initially proposed in February 2024, and excludes from the definition RIAs that register with the SEC solely because they are (i) mid-sized advisers, (ii) multi-state advisers, or (iii) pension consultants; as well as RIAs that are not required to report any AUM to the SEC on Form ADV.

The final rule also addresses comments relating to how the proposed rule would apply to RIAs or ERAs that have a principal office and place of business outside the United States. For these investment advisers (defined as "foreign-located investment advisers" in the final rule), the final rule only applies to their advisory activities that (i) take place within the United States, including through the involvement of US personnel of the investment adviser or (ii) provide advisory services to a US person or a foreign-located private fund with an investor that is a US person.

Certain proposed rules

Proposed Safeguarding Rule

On 15 February 2023, the SEC issued a proposed rule to significantly amend Rule 206(4)-2 of the Advisers Act, more commonly known as the custody rule (the "Custody Rule"). The proposed rule would replace the Custody Rule with Rule 223-1 (the "Safeguarding Rule"). Beyond a change in nomenclature, the proposed Safeguarding Rule would greatly expand the scope of RIA's responsibilities and duties to their clients, including private funds.

SEC proposed rule on outsourcing by investment advisers

On 26 October 2022, the SEC proposed Rule 206(4)-11, a new rule under the Advisers Act that would prohibit RIAs from outsourcing certain services without meeting the requirements set forth in the rule. If adopted, the proposed rule would introduce four main requirements for RIAs: (i) due diligence and monitoring; (ii) books and records; (iii) oversight of service providers serving as recordkeepers; and (iv) changes to Form ADV.

Proposed rule to address conflicts of interest associated with the use of predictive data analytics by investment advisers

On 26 July 2023, the SEC proposed new rules under the Advisers Act to eliminate, or neutralise the effect of, certain conflicts of interest associated with investment advisers' interactions with investors using technologies that optimise for, predict, guide, forecast, or direct investment-related behaviours or outcomes. The SEC also proposed similar amendments to rules under the Exchange Act for broker-dealers.

Certain regulatory initiatives

Continued focus on the Marketing Rule

The SEC continues to focus on compliance with Rule 206(4)-1 under the Advisers Act (the "Marketing Rule").

On 17 April 2024, the Division of Examinations (the "Division") of the SEC released a Risk Alert, "Initial Observations Regarding Advisers Act Marketing Rule Compliance", which provides observations related to investment advisers' compliance with the Marketing Rule.

The Division generally observed policies and procedures that were not "reasonably designed or implemented to address compliance with the Marketing Rule", which resulted in gaps for preventing violations of the Marketing Rule.

Off-channel communications

The SEC has ramped up its investigations of "off-channel" communications taking place at broker-dealers and RIAs. Generally, an "off-channel" communication is a communication, whether internal or external, using personal texting platforms and other electronic communication services that are not approved by the firm.