ICLG

The International Comparative Legal Guide to:

Alternative Investment Funds 2017

5th Edition

A practical cross-border insight into Alternative Investment Funds work

Published by Global Legal Group, in association with AIMA, with contributions from:

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Published by
Global Legal Group Ltd.
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London SE1 3PL, UK
Tel: +44 20 7367 0720
Fax: +44 20 7407 5255
Email: info@glgroup.co.uk
URL: www.glgroup.co.uk

GLG Cover Design
F&F Studio Design

GLG Cover Image Source
iStockphoto

Printed by
Ashford Colour Press Ltd
June 2017

ISBN 978-1-911367-55-0
ISSN 2051-9613

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1 Regulatory Framework

1.1 What legislation governs the establishment and operation of Alternative Investment Funds?

Overview of the Commonwealth of Puerto Rico's Laws and Regulations

The Commonwealth of Puerto Rico ("**Puerto Rico**") is an unincorporated territory of the United States of America ("**United States**"). Puerto Rico has a republican government system and has its own Constitution, laws and regulations. In addition, Puerto Rico enjoys United States constitutional, legal, financial and regulatory protection. Furthermore, besides the local court system, Puerto Rico has its own United States District Court and its decisions are subject to appeal to the First Circuit Court of Appeals in Boston, Massachusetts and then to the United States Supreme Court.

The official currency of Puerto Rico is the United States dollar. Puerto Rico's banking system and its financial institutions (including investment advisers, investment companies and broker/dealers) are subject to United States laws and regulations. Bank deposits are insured by the Federal Deposit Insurance Company and Puerto Rico's geographic access points are protected by the United States Customs and Border Patrol.

Legislation Applicable to Alternative Investment Funds

In general, alternative investment funds (an "**Alternative Investment Fund**" or a "**Fund**") are regulated in a similar manner to Alternative Investment Funds organised in the continental United States in the sense that they are subject to both federal laws and regulations and the laws and regulations of the state in which they are formed and/or doing business. It is important to note that Puerto Rico's securities and investment adviser laws and regulations are modelled after the model laws and regulations published by the North American Securities Administrators Association, Inc. ("**NASAA**"), and that the local regulator, the Office of the Commissioner of Financial Institutions of Puerto Rico ("**OCFI**"), is a member of NASAA.

Select United States Legislation

As mentioned above, Alternative Investment Funds and their Investment Advisers organised under the laws of Puerto Rico and/or doing business in Puerto Rico are subject to the laws of the United States and all applicable rules and regulations promulgated by the Securities and Exchange Commission (the "**SEC**").

- Investment Companies Act of 1940 (the "**ICA**"): The ICA regulates "investment companies" that issue securities and are primarily in the business of investing in securities. As further discussed below, Alternative Investment Funds rely on certain exemptions in order to be exempt from the provisions of the ICA.
- Investment Advisers Act of 1940 (the "**Advisers Act**"): The Advisers Act regulates the business of persons engaged in providing advice to other persons, for compensation, with regard to investment in securities. A person advising a Fund generally meets the definition of an "investment adviser" under the Advisers Act.
- Securities Act of 1933 (the "**Securities Act**"): The offering and sale of ownership interest or securities in Alternative Investment Funds are subject to the provisions of the Securities Act.
- Securities Exchange Act of 1934 (the "**Exchange Act**"): The sale and transfer of the ownership interest in Alternative Investment Funds are subject to the provisions of the Exchange Act.
- Internal Revenue Code of 1984 (the "**IRC**"): Alternative Investment Funds are generally structured as partnerships. As further explained below, the investors in an Alternative Investment Fund could be subject to different tax treatments (e.g. individuals *vs.* business entities; domestic persons *vs.* foreign persons).
- Others: Alternative Investment Funds and their Investment Advisers could be subject to regulation by the Commodity Futures Trading Commission (the "**CFTC**") if the investment strategies of the Fund involve certain types of derivative securities (e.g. futures, options, and certain swaps, among others). Other regulators include the Financial Industry Regulatory Authority ("**FINRA**") and the Federal Reserve Board with respect to Alternative Investment Funds affiliated with or sponsored by banks.

Select Puerto Rico Legislation

- Puerto Rico Uniform Securities Act ("**PRUSA**"): PRUSA is modelled after the NASAA's Model Uniform Securities Act. Among other matters, PRUSA regulates the registration of Investment Advisers and the offer and sale of securities (unless federal pre-emption applies).
- Puerto Rico General Corporations Act (the "**PR Corporations Act**"): The PR Corporations Act establishes the framework on the constitution and governance of corporations and limited liability companies in Puerto Rico. It is modelled after the Delaware General Corporations Act (the "**Delaware Corporations Act**") and the Delaware Limited Liability Companies Act (the "**DLLC Act**"). The Puerto Rico Supreme Court has stated that judicial decisions from Delaware courts in connection with the interpretation of the Delaware Corporations Act are highly persuasive and illustrative before Puerto Rico courts.
- Puerto Rico Investment Companies Act of 2013: (the "**PR ICA**"): The PR ICA established the framework for the

organisation and operation of local investment companies and it is modelled after the ICA. Please note that the PR ICA expressly states that it shall not apply to any investment company that is excluded from the definition as an "investment company" under Section 3(b), 3(c)(1) and 3(c)(7) of the ICA. This chapter will not discuss the provisions of the PR ICA and regulations promulgated thereunder, given that Alternative Investment Funds are structured in order to be exempt under ICA.

- Puerto Rico Internal Revenue Code ("**PR IRC**"): Puerto Rico has a unique tax system, which is intertwined with the United States tax system. It enjoys fiscal autonomy with respect to local tax matters. Notwithstanding, given that Puerto Rico born individuals are also United States citizens, they are subject to worldwide taxation. However, pursuant to Section 933 of the IRC, *bona fide* residents of Puerto Rico are not subject to federal income tax on their Puerto Rico sourced income, providing for unique tax structures. With regard to entities, the IRC excludes Puerto Rican entities from the definition of "United States Person" and treats them as foreign. Therefore, as with individuals, Puerto Rican entities and entities organised outside the United States doing business in Puerto Rico are not subject to United States income tax, except to the extent that they (a) engage in trade or business within the United States, or (b) derive certain categories of investment income from United States sources.

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

Yes, managers or advisers to Alternative Investment Funds are required to be licensed, unless an exception from registration applies. Pursuant to the Advisers Act and PRUSA, Investment Advisers are required to be registered with the SEC or with OCFI, unless an exception from registration applies. Under both statutes, a 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 must register with the SEC or with OCFI, as applicable.

Generally, and subject to certain exceptions, the level of assets under management ("**AUM**") of an Investment Adviser determines whether it should register with the SEC or with a state regulatory body, such as OCFI with regard to Puerto Rico-based Investment Advisers.

- Small Advisers: Investment Advisers with less than USD 25 million in AUM are regulated by the states unless the state in which the adviser has its principal office and place of business has not enacted a statute regulating advisers.
- Medium Advisers: Investment Advisers with more than USD 25 million and less than USD 100 million in AUM are regulated by the states if (i) the Investment Adviser is registered with the local regulator in the state in which it has its principal office, and (ii) it is subject to examination by the local regulator.
- Large Advisers: Investment Advisers with more than USD 100 million but less than USD 110 million in AUM may, but are not required to, register with the SEC. Once AUM exceed USD 110 million, the Investment Adviser must register with the SEC. Once an Investment Adviser registers with the SEC, state laws and regulations pertaining to investment advisers are pre-empted.

Notwithstanding the foregoing, there are various exemptions from registration at the federal and Puerto Rico level that Investment Advisers to Alternative Investment Funds may rely on:

Federal Level

Private Fund Adviser Exemption (SEC Rule 203(m)-1):

- SEC Rule 203(m)-1 provides an exemption from registration to Investment Advisers with their principal office and place of business in the United States who (i) only advise "qualifying private funds", and (ii) have less than USD 150 million in AUM in the United States (which is defined to include Puerto Rico).
- The term "qualifying private fund" is defined to mean any (i) private fund that is not registered under Section 8 of the ICA, (ii) private fund that has not elected to be treated as a business development company under Section 54 of the ICA, and (iii) issuer that qualifies for an exclusion from the definition of an "investment company" under Section 3 of the ICA in addition to those provided by Section 3(c)(1) or 3(c)(7) of the ICA where the Investment Advisers treat the issuer as a private fund.
- Non-United States Investment Advisers (no principal office or place of business in the United States) are exempt from registration under Section 203 of the Advisers Act if (i) the Investment Adviser has no clients that are United States persons except for one or more qualifying private funds, and (ii) has less than USD 150 million in AUM in the United States attributable to private fund assets.
- Investment Advisers relying on the Private Fund Adviser Exemption are subject to record-keeping and reporting requirements and are classified by the SEC as "Exempt Reporting Advisers". They are required to prepare and file a "short-form" version of Form ADV.

Venture Capital Fund Adviser Exemption (Section 203 of the Advisers Act and SEC Rule 203(l)-1):

- Section 203(l) of the Advisers Act exempts Investment Advisers from registration when they solely advise one or more "venture capital funds" as defined by the SEC.
- Under SEC Rule 203(l)-1, a "venture capital fund" is a private fund that: (i) represents to investors and potential investors that it pursues a venture capital strategy; (ii) immediately after the acquisition of any asset, other than qualifying investments or short-term holdings, holds no more than 20% of the amount of the fund's aggregate capital contributions and uncalled committed capital in assets (other than short-term holdings) that are not qualifying investments, valued at cost or fair value, consistently applied by the fund; (iii) does not borrow, issue debt obligations, provide guarantees or otherwise incur leverage in excess of 15% of the private fund's aggregate capital contributions and uncalled committed capital, and any such borrowing, indebtedness, guarantee or leverage is for a non-renewable term of no longer than 120 calendar days, except that any guarantee by the private fund of a qualifying portfolio company's obligations up to the amount of the value of the private fund's investment in the qualifying portfolio company is not subject to the 120-calendar-day limit; (iv) only issues securities the terms of which do not provide a holder with any right, except in extraordinary circumstances, to withdraw, redeem or require the repurchase of such securities but may entitle holders to receive distributions made to all holders *pro rata*; and (v) is not registered under Section 8 of the ICA, and has not elected to be treated as a business development company pursuant to Section 54 of the ICA.
- The main difference between the Venture Capital Fund Adviser Exemption and the Private Fund Adviser Exemption is that Investment Advisers relying on the Venture Capital Fund Adviser Exemption can have AUM in excess of USD 150 million without having to register with the SEC.
- Investment Advisers relying on the Venture Capital Fund Adviser Exemption are subject to the same record-keeping and reporting requirements as Investment Advisers relying on the Private Fund Adviser Exemption.

Puerto Rico Level

On October 20, 2014, OCFI adopted Regulation 8526, which is modelled after NASAA's Registration Exemption for Investment Advisers to Private Funds Model Rule and provides an exemption from registration to advisers of private funds and of venture capital funds that comply with certain requirements.

Under Regulation 8526, an Investment Adviser shall be exempt from registration with OCFI if it satisfies the following conditions:

- neither the Investment Adviser nor any of its advisory affiliates are subject to an event that would disqualify an issuer under Rule 506(d)(1) of SEC Regulation D;
- the Investment Adviser files with OCFI each report and amendment thereto that an Exempt Reporting Adviser is required to file with the SEC, pursuant to SEC Rule 204-4; and
- if the Investment Adviser provides advice to at least one Fund that relies on Section 3(c)(1) of the ICA, that is not a venture capital fund, it must also comply with the following requirements:
  - the Investment Adviser shall advise only Funds (other than venture capital funds) where the outstanding securities (other than short-term paper) are beneficially owned entirely by persons who, after deducting the value of the primary residence from the person's net worth, would each meet the definition of a "Qualified Client" under SEC Rule 205-3 at the time the securities are purchased from the issuer:
    - as of March 2017, a person needs a net worth of at least USD 2.1 million in order to be classified as a Qualified Client under SEC Rule 205-3;
  - at the time of purchase, the Investment Adviser must disclose to each investor: (i) all services, if any, to be provided to individual investors; (ii) all duties, if any, which the investment adviser owes to the investors; and (iii) any other material information affecting the rights or responsibilities of the investors; and
  - the Investment Adviser must obtain, on an annual basis, audited financial statements of the Fund, and shall deliver a copy of such audited financial statements to each beneficial owner of the Fund.

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

The ICA regulates all entities that fall under the definition of an investment company. Pursuant to the ICA, an "investment company" is: any issuer that is or holds itself out as being engaged, or proposes to engage, primarily in the business of investing, reinvesting, or trading in securities. However, there are two main exemptions from registration on which Alternative Investment Funds rely:

- Section 3(c)(1): An issuer will not be considered an "investment company" if said issuer securities are owned by not more than 100 persons and the issuer has not made nor proposes to make a public offering of its securities.
- Section 3(c)(7): An issuer will not be considered an "investment company" if said issuer securities are exclusively owned by person who, at the time of acquisition of such securities, are "Qualified Purchasers" as defined in question 3.6 below and the issuer has not and does not propose to make a public offering of its securities.

Pursuant to the PR ICA, an entity that would be an "investment company" *but for* Sections 3(b), Section 3(c)(1) or Section 3(c)(7), is exempt from the requirements of the PR ICA. As such, Alternative Investment Funds organised and/or operating in Puerto Rico are structured in order to meet the requirements of Sections 3(c)(1) or 3(c)(7).

1.4 Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds) and if so how?

No. Neither United States nor Puerto Rico laws and regulations distinguish between open-ended and closed-ended Alternative Investment Funds. Such distinctions are generally seen with regulated investment companies (i.e. mutual funds registered under the ICA or the PR ICA).

1.5 What does the authorisation process involve?

Alternative Investment Fund Entity

Assuming that the Alternative Investment Fund is an on-shore entity, it could be organised as a Delaware limited partnership or limited liability company or as a Puerto Rico limited liability company. As such, it would need to file the corresponding organisational documents in Delaware or Puerto Rico, as applicable, and would also be required to make other business filings and permits which are outside the scope of this chapter. Please note that in order to rely on the private offering exemption under Regulation D, the Alternative Investment Fund would need to prepare and file Form D upon the first sale of its securities.

Investment Adviser and General Partner/Managing Member Entity

The entity or entities that will be organised to serve as the Investment Adviser and as the General Partner/Managing Member of the Alternative Investment Fund will also be required to file a Certificate of Organization with the Delaware State Department or the Puerto Rico State Department, depending on the structure chosen by the sponsors. If any of these entities were organised in Delaware and want to engage in business in Puerto Rico, then they will have to file an Authorization to do Business Certificate with the Puerto Rico State Department. In addition, they will be required to file other customary business filings and permits which are outside the scope of this chapter.

The Investment Adviser, whether registering with the SEC, with OCFI or as an Exempt Reporting Adviser, will be required to file Form ADV. If the Investment Adviser registers with the SEC or with OCFI, it will be required to complete in full Form ADV, as opposed to the "short-form" version that is required from Exempt Reporting Advisers.

1.6 Are there local residence or other local qualification requirements?

If an Investment Adviser decides to register with OCFI as a "state-registered" Investment Adviser, it will be required to have a surety bond in the amount of USD 10,000 or USD 25,000 (if the entity's net capital is less than USD 25,000). In addition, the Investment Adviser will be required to appoint the Commissioner of OCFI as its agent to receive service of process in Puerto Rico.

1.7 What service providers are required?

Generally, Alternative Investment Funds and Investment Advisers engage: (i) accountants; (ii) independent accountants to serve as auditors; (iii) legal counsel; (iv) fund administrators; (v) custodians; (vi) banks; and (vii) broker/dealers.

Please note that if an Investment Adviser is considered to have custody of an Alternative Investment Fund's assets, said Investment Adviser must take certain precautions or safeguards to protect the client's assets. For example, an Investment Adviser should engage a "Qualified Custodian" (which includes banks, broker/dealers, and other entities) to hold and maintain the Alternative Investment Fund's assets and have an independent public accountant audit the Fund's financial statements and/or be subject to examination by an independent public accountant.

1.8 What co-operation or information sharing agreements have been entered into with other governments or regulators?

The United States and Puerto Rico have entered into information sharing agreements and memorandums of understanding with multiple governments and regulators.

2 Fund Structures

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

The principal legal structure to organise Alternative Investment Funds in Puerto Rico is the Limited Liability Company ("**LLC**"). However, it is also common for Alternative Fund sponsors to organise the Alternative Investment Fund entity as a Delaware Limited Partnership ("**LP**") or as a Delaware LLC. In addition, the sponsors, for regulatory and tax reasons, may organise fund entities in other tax-neutral jurisdictions, such as the Cayman Islands. Both LLCs and LPs grant ample flexibility to the parties regarding the terms and conditions that will govern the activities and functionality of the Alternative Investment Fund.

Due to the applicability of federal laws and regulations and the similarity of Puerto Rico securities laws and regulations to those of most states in the United States, Alternative Investment Funds organised in Puerto Rico generally follow the same structures developed by US-based Alternative Investment Funds.

In the most basic Alternative Investment Fund structure, there will be (i) the Alternative Investment Fund entity (either an LLC or LP), (ii) a Managing Member or General Partner entity (organised as an LLC or as a Corporation), and (iii) an Investment Adviser entity (organised as an LLC or as a Corporation). From the foregoing basic structure, an Alternative Investment Fund may expand and include multiple other entities.

It is also common to see other Alternative Investment Fund that are structured to include: (i) parallel funds organised in other jurisdictions (such as the Cayman Islands or the British Virgin Islands) to accommodate investors that might be subject to particular tax, regulatory regimes or other investment limitations; and (ii) so-called "blocker" entities that permit tax-exempt entities or foreign investors to "block" United States sourced income generated by the Fund investments that could trigger certain income tax obligations.

2.2 Please describe the limited liability of investors.

Alternative Investment Funds organised as either (i) Puerto Rico LLCs, or (ii) Delaware LLCs provide statutory limited liability to all of their investors. As such, the investors are not liable for the obligations of the Alternative Investment Fund, whether incurred in contract, tort or otherwise.

Alternative Investment Funds organised as Delaware LPs offer limited liability to the limited partners unless they actively engage and participate in the business of the LP.

2.3 What are the principal legal structures used for managers and advisers of Alternative Investment Funds?

Generally, the managers and advisers of an Alternative Investment Fund are organised as Puerto Rico LLCs. Furthermore, for tax and liability considerations, the manager and adviser roles are divided in two entities: (i) an entity to serve as the General Partner (with respect to Delaware LPs) or Managing Member (with respect to Delaware or Puerto Rico LLCs); and (ii) an entity to serve as the Investment Adviser which could be either a Corporation or an LLC.

Although infrequent, if the Alternative Investment Fund is structured as a Delaware or Puerto Rico LLC, the sponsors may choose a simpler structure in which one entity serves as both the Managing Member and as the Investment Adviser of the Alternative Investment Fund. This structure could provide certain savings from a regulatory and compliance perspective (e.g. less tax filings, state filing fees, and other regulatory disclosures). The choice of the structure will depend on multiple factors, the most important of which are those related to (i) the type of investment that will be made by the Fund, (ii) tax considerations, and (iii) the type of investors in the Fund.

2.4 Are there any limits on the manager's ability to restrict redemptions in open-ended funds or transfers in open-ended or closed-ended funds?

The concept of open-ended and closed-ended funds does not apply to Alternative Investment Funds that are exempt from the ICA and the PR ICA. As such, under local legislation there are no limits regarding the restriction of redemptions and/or transfers in Alternative Investment Funds.

It is a common and even necessary characteristic for Alternative Investment Funds to restrict and/or limit redemptions, withdrawals and transfers. Generally, hedge funds provide certain limited redemption and/or withdrawal rights to investors (e.g. quarterly windows to withdraw money). On the other hand, private equity funds do not provide withdrawal rights.

Similarly, transfers of the ownership of an Alternative Investment Fund interest are generally prohibited unless otherwise approved by the General Partner/Managing Member in its sole and absolute discretion.

All these conditions are negotiated in the Alternative Investment Fund governance documents (i.e. LP Partnership Agreement or LLC Operating Agreement).

2.5 Are there any legislative restrictions on transfers of investors' interests in Alternative Investment Funds?

Alternative Investment Funds restrict the transfer of investors' interest in order to limit the risks of losing the exemption from registration under the ICA, the Securities Act, the Exchange Act and PRUSA. In addition, securities offered pursuant to Rule 506 of Regulation D are classified as "restricted securities", which means that the securities cannot be sold for at least a year without registering them under the Securities Act.

3 Marketing

3.1 What legislation governs the production and offering of marketing materials?

The legislation that governs the production and offering of marketing materials is the Exchange Act. Under Section 10(b) of the Exchange Act, it is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or mail, or of any facility of any national securities exchange, to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to said power, the SEC promulgated Rule 10(b)-5 which states that it is unlawful for any person, directly or indirectly, to employ any device, scheme or artifice to defraud, to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading or to engage in any act, practice or course of business which operates as a fraud or deceit upon any person in connection with the purchase or sale of any security.

3.2 What are the key content requirements for marketing materials, whether due to legal requirements or customary practice?

Besides the provisions of Section 10(b) of the Exchange Act and of Rule 10(b)-5 promulgated thereunder, the Investment Advisers of Alternative Investment Funds must be aware of the provisions of Section 206 of the Advisers Act, which make it unlawful for any Investment Adviser: (i) to directly or indirectly employ any device, scheme, or artifice to defraud any client or prospective client; (ii) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; (iii) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction; or (iv) to engage in any act, practice or course of business which is fraudulent, deceptive or manipulative.

Please note that under Rule 206(4)-8 of the Advisers Act, it shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business within the meaning of Section 206(4) of the Advisers Act for any Investment Adviser to a pooled investment vehicle to: (i) make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or (ii) otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.

Investment Advisers should also take into consideration the provisions of Rule 206(4)-1 and related SEC No-Action Letters with regard to advertisements by Investment Advisers.

3.3 Do the marketing or legal documents need to be registered with or approved by the local regulator?

Alternative Investment Funds generally offer and sell their securities to "Accredited Investors" pursuant to the exemption from registration available under Rule 506(b) of Regulation D of the Securities Act to private offerings that do not engage in general solicitation or advertising. As such, neither the SEC nor OCFI impose any requirements regarding the registration or approval of the marketing and legal documentation provided by the Alternative Investment Fund to potential investors.

It is common practice to include in the Fund's legal and marketing documents certain disclosure language that expressly states that the offering materials and the legal documents have not been registered, reviewed or approved with any regulatory agency.

3.4 What restrictions are there on marketing Alternative Investment Funds?

Under the Securities Act and PRUSA, securities offered and sold in the United States must be registered with the SEC and/or PRUSA, as may be applicable, unless an exemption from registration applies.

Given the extensive disclosure and regulatory requirements under the Securities Act, Alternative Investment Funds rely on the private offering exemption available under Section 4(a)(2) of the Securities Act. Particularly, Alternative Investment Funds rely on the safe harbour provided under Regulation D (for example, Rule 506(b)), which requires, among others, that the sale of securities under said Rule be made only to "Accredited Investors" with an allowance of a maximum of 35 "Non-Accredited Investors" and that no public offering or solicitation be made.

3.5 Can Alternative Investment Funds be marketed to retail investors?

Prior to the enactment of Rule 506(c) under Regulation D, no issuer that was relying on the private offering exemption under the Securities Act could publicly market, offer or solicit its securities. Furthermore, in order to comply with the safe-harbour provisions under Regulation D, the offer and sale of securities had to be made to "Accredited Investors" as defined in question 3.6 below. As such, the marketing of Alternative Investment Funds was strictly limited. Compliance with the private offering exemption is a matter of high importance because it is one of the factors to be eligible for exemption from registration under Sections 3(c)(1) and 3(c)(7) of the ICA.

Now, pursuant to Rule 506(c), issuers can solicit and generally advertise an offering while still being deemed to be undertaking a private offering pursuant to Section 4(a)(2) of the Securities Act if: (i) all the investors in the offering are "Accredited Investors"; and (ii) the issuer has taken reasonable steps to verify that the investors are accredited investors. Under Rule 506(c), the mere representation of an investor that it is an "Accredited Investor" is not enough and among the reasonable steps that can be taken are: (i) verifying the income via the receipt and review of IRS W-2 Forms; and (ii) receiving a certification from a certified public accountant, a lawyer, a registered broker/dealer, among others, stating that the investor, in fact, complies with the requirements to be classified as an "Accredited Investor" under Rule 501 of Regulation D.

3.6 What qualification requirements must be carried out in relation to prospective investors?

Qualifications Related to Regulation D Offerings and the ICA

As discussed in other parts of this chapter, Alternative Investment Funds offer and sell their securities to "Accredited Investors" pursuant to private offerings in order to be exempt from registration under the Securities Act and in order for the Alternative Investment Fund to be eligible for exemption from registration under Section 3(c)(1) of the ICA (which allows a maximum of 100 investors).

Pursuant to Rule 501 of Regulation D, an "Accredited Investor" includes, among others, the following persons:

- Certain institutional investors such as banks, broker/dealers, insurance companies; any plan established and maintained by a state, its political subdivisions, or any agency or instrumentality of a state or its political subdivisions, for the benefit of its employees, if such plan has total assets in excess of USD 5,000,000; any employee benefit plan within the meaning of the Employee Retirement Income Security Act of 1974 if the investment decision is made by a plan fiduciary, which is either a bank, savings and loan association, insurance company, or registered investment adviser, or if the employee benefit plan has total assets in excess of USD 5,000,000 or, if a self-directed plan, with investment decisions made solely by persons that are accredited investors.
- Any director, executive officer, or general partner of the issuer of the securities being offered or sold, or any director, executive officer, or general partner of a general partner of that issuer.
- Any natural person whose individual net worth, or joint net worth with that person's spouse, exceeds USD 1,000,000 (excluding that person's primary residence and any indebtedness secured by the primary residence up to a certain limit).
- Any natural person who had an individual income in excess of USD 200,000 in each of the two most recent years, or joint income with that person's spouse in excess of USD 300,000 in each of those years, and has a reasonable expectation of reaching the same income level in the current year.
- Any trust, with total assets in excess of USD 5,000,000, not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person.
- Any entity in which all of the equity owners are accredited investors.

If the Alternative Investment Fund intends to rely on the exemption from registration available under Section 3(c)(7) of the ICA (which allows more than 100 investors in the Fund), all investors must be "Qualified Purchasers" or knowledgeable employees. Under the ICA, a "Qualified Purchaser" includes, among others, the following persons:

- Any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under Section 3(c)(7) of the ICA with that person's qualified purchaser spouse) who owns not less than USD 5,000,000 in investments.
- Any company that owns not less than USD 5,000,000 in investments and that are owned directly or indirectly by or for two or more natural persons who are related as siblings or spouse (including former spouses), or direct lineal descendants by birth or adoption, spouses of such persons, the estates of such persons, or foundations, charitable organisations, or trusts established by or for the benefit of such persons.
- Any trust that is not covered by the point above and that was not formed for the specific purpose of acquiring the securities offered, 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 person described in the preceding paragraphs or the paragraph below.
- Any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than USD 25,000,000 in investments.

Qualifications Related to Performance Fees/Carried Interest Charged to Investors

Under the Advisers Act and PRUSA, Investment Advisers are prohibited to enter into an agreement that provides for compensation to the Investment Adviser on the basis of a share of capital gains upon, or capital appreciation of, the funds or any portion of the funds of the client. However, under Rule 205-3, an Investment Adviser is not prohibited from entering into performing, renewing or extending an investment advisory contract that provides for compensation to the Investment Adviser on the basis of a share of the capital gains upon, or the capital appreciation of, the funds, or any portion of the funds, of a client if, and only if, the client meets the requirements to be classified as a "Qualified Client" under Rule 205-3.

The term "Qualified Client" means:

- a natural person who, or a company that, immediately after entering into the contract has at least USD 1,000,000 under the management of the Investment Adviser;
- a natural person who, or a company that, the Investment Adviser entering into the contract (and any person acting on his behalf) reasonably believes, immediately prior to entering into the contract, either:
  - has a net worth (together, in the case of a natural person, with assets held jointly with a spouse) of more than USD 2,000,000 (excluding the person's primary residence and any indebtedness secured by the primary residence); or
  - is a qualified purchaser as defined in Section 2(a)(51)(A) of the ICA at the time the contract is entered into; or
- a natural person who immediately prior to entering into the contract is an executive officer, director, trustee, general partner, or person serving in a similar capacity, of the investment adviser; or an employee of the investment adviser (other than an employee performing solely clerical, secretarial or administrative functions with regard to the investment adviser) who, in connection with his or her regular functions or duties, participates in the investment activities of such investment adviser and has engaged in those functions for at least 12 months.

3.7 Are there additional restrictions on marketing to public bodies such as government pension funds?

Federal Restrictions

Under Rule 206(4)-5 of the Advisers Act (the "Pay-to-Play Rule"), it is unlawful: (1) for any Investment Adviser to provide investment advisory services for compensation to a government entity within two years after a contribution to an official of the government entity is made by the Investment Adviser or any covered associate of the Investment Adviser (including a person who becomes a covered associate within two years after the contribution is made); and (2) for any Investment Adviser or a covered associate (a) to provide or agree to provide, directly or indirectly, payment to any person to solicit a government entity for investment advisory services on behalf of such Investment Adviser unless such person is a regulated person or an executive officer, general partner, managing member (or, in each case, a person with a similar status or function), or employee of the

Investment Adviser, and (b) to coordinate, or to solicit any person or political action committee to make, any contribution to an official of a government entity to which the investment adviser is providing or seeking to provide investment advisory services or any payment to a political party of a state or locality where the investment adviser is providing or seeking to provide investment advisory services to a government entity.

The prohibitions set forth above do not apply to contributions made by a covered associate (if a natural person) to officials for whom the covered associate was entitled to vote at the time of the contributions and which in aggregate do not exceed USD 350 to any one official, per election, or to officials for whom the covered associate was not entitled to vote at the time of the contributions and which in aggregate do not exceed USD 150 to any one official, per election. In addition, the prohibitions shall not apply to an Investment Adviser as a result of a contribution made by a natural person more than six months prior to becoming a covered associate of the Investment Adviser unless such person, after becoming a covered associate, solicits clients on behalf of the Investment Adviser. Further, an Investment Adviser may be exempted from the prohibitions discussed above if it complies with the following: (1) the Investment Adviser must have discovered the contribution which resulted in the prohibition within four months of the date of such contribution; (2) such contribution must not have exceeded USD 350; and (3) the contributor must obtain a return of the contribution within 60 calendar days of the date of discovery of such contribution by the investment adviser.

Puerto Rico Restrictions

The Puerto Rico Code of Ethics for Contractors and Suppliers of Goods and Services (Act 84 of 2002, as amended) generally prohibits any person from offering or delivering to a public servant of the executive agencies – with whom the person wishes to establish or has established a contractual or commercial or financial relationship – any contributions or donations, among other things. A related provision of the Code of Ethics prohibits a person who has "actively participated in political campaigns", from establishing negotiations with secretaries, heads of agencies, municipal executives or executive directors of public corporations, that may lead to the improper granting of advantages or favours for their benefit.

In addition, pursuant to the Puerto Rico Political Campaign Financing Oversight Act (Act 222 of 2011, as amended), there is a clear prohibition that business entities shall not make contributions out of their own resources in or outside Puerto Rico to any political party, aspirant, candidate, campaign committee, or to any authorised agent, representative, or committee thereof, or to political action committees that make contributions to or coordinate expenditure among such entities.

However, a business entity may establish, organise, and administer a committee, to be known as a segregated committee or fund that, for the purposes of contributions and expenditures, shall be treated as a political action committee that must be registered in the Office of the Election Comptroller of Puerto Rico, render reports, and comply with all requirements imposed under the Political Campaign Financing Oversight Act. Thus, the business entity members, employees, and their immediate family or related persons may make contributions that shall be deposited in the account established and registered in the Office of the Election Comptroller.

In order for a business entity to be able to establish a segregated committee or fund for these purposes, it must comply with the limitations and requirements set forth in Section 625j of the Political Campaign Financing Oversight Act. The committee, organisation or citizen group may make donations from said account to political parties, aspirants, candidates, and campaign committees and authorised committees, as well as to political action committees making contributions to any of them. Please note that the donations that the committee makes are subject to the limits applicable to natural persons. Currently, said amount equals to USD 2,600 per calendar year (which shall rise alongside Puerto Rico's inflation rate, as adjusted by the Electoral Comptroller).

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

There are certain restrictions as to the type of intermediaries that an Alternative Investment Fund may use in the sale of its securities to raise funds. Under Section 15 of the Exchange Act, it is unlawful for any broker or dealer to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security unless such broker or dealer is registered with the SEC. Similarly, it is unlawful for a broker or dealer to engage in business in Puerto Rico unless said broker or dealer is registered under PRUSA. The term "broker" is defined to mean "any person engaged in the business of effecting transaction in securities for the accounts of others". As such, an intermediary engaged in the offering or sale of securities of an Alternative Investment Fund must be a registered broker/dealer or be exempt from registration as such.

Now, the safe harbour provided by Rule 3a4-1 of the Exchange Act allows certain associated persons of an Alternative Investment Fund (i.e. the issuer of the securities) to engage in the sale of securities without being deemed to be a broker or dealer if such person is not:

- subject to a statutory disqualification, as that term is defined in Section 3(a)(39) of the Exchange Act, at the time of his participation;
- compensated in connection with his participation by the payment of commissions or other remuneration based either directly or indirectly on transactions in securities; and
- an associated person of a broker or dealer at the time of his participation.

The term "associated person" includes any natural person who is a partner, officer, director or employee of the issuer, a corporate general partner of a limited partnership that is the issuer, a company or partnership that controls, is controlled by, or is under common control with, the issuer or an investment adviser registered under the Advisers Act to an investment company registered under the ICA which is the issuer.

Alternative Investment Funds must be aware that the use of persons that engage in activities that would classify them as brokers or dealers, such as persons engaged as "finders", entails substantial risks and sanctions. For example, the Alternative Investment Fund could be forced to rescind the subscription agreements entered into with investors and be ordered to return in its entirety all of the capital that was raised from said investors.

3.9 Are there any restrictions on the participation in Alternative Investments Funds by particular types of investors, such as financial institutions (whether as sponsors or investors)?

Under Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (which added a new Section 13 to the Bank Holding Company Act), banking entities are generally prohibited from "engaging in proprietary trading or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with a Hedge Fund or Private Equity Fund, subject to certain exemptions".

Under Section 13(d)(1)(G), a banking institution is permitted to organise and offer a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses for the foregoing, only if:

- the banking entity provides *bona fide* trust, fiduciary, or investment advisory services;
- the Fund is organised and offered only in connection with the provision of *bona fide* trust, fiduciary, or investment advisory services and only to persons that are customers of such services of the banking entity;
- the banking entity does not acquire or retain an equity interest, partnership interest, or other ownership interest in the Funds except for a *de minimis* investment (which, no later than one year after the date of the establishment of the Fund, cannot amount to more than 3% of the total ownership interests in the Fund and the aggregate investment of the banking entity in Funds cannot amount to more than 3% of the Tier 1 Capital of the banking entity);
- the banking entity complies with the restrictions under paragraphs (1) and (2) of subparagraph (f) of Section 13 regarding certain relationships with Alternative Investment Funds;
- the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the Hedge Fund or Private Equity Fund or of any Hedge Fund or Private Equity Fund in which such Hedge Fund or Private Equity Fund invests;
- the banking entity does not share with the Hedge Fund or Private Equity Fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name;
- no director or employee of the banking entity takes or retains an equity interest, partnership interest, or other ownership interest in the Hedge Fund or Private Equity Fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the Hedge Fund or Private Equity Fund; and
- the banking entity discloses to prospective and actual investors in the Fund, in writing, that any losses in such Hedge Fund or Private Equity Fund are borne solely by investors in the Fund and not by the banking entity, and otherwise complies with any additional rules of the appropriate federal banking agencies, the SEC, or the CFTC, as provided in Section 13, designed to ensure that losses in such Hedge Fund or Private Equity Fund are borne solely by investors in the Fund and not by the banking entity.

Besides the restrictions imposed by the Dodd-Frank Act, the only rules and regulations that could be considered as restrictions on the type of investor that can invest in an Alternative Investment Fund are those regarding the net worth and sophistication requirements under Rule 506. As discussed in other parts of this chapter, Alternative Investment Funds limit the sale of securities to investors that meet the requirements to be classified as "Accredited Investors" under Regulation D of the Securities Act and as "Qualified Clients" under Rule 205-3 of the Advisers Act in order to protect the Fund's reliance on the safe harbour provisions and reduce the risks of running afoul of the ICA.

4 Investments

4.1 Are there any restrictions on the types of activities that can be performed by Alternative Investment Funds?

Generally, there are no restrictions on the types of activities that can be performed by an Alternative Investment Fund, as long as those activities are lawful and permitted under federal and Puerto Rico laws and regulations. Please note that the governing documents of an Alternative Investment Fund may limit the types of activities that it can perform.

Notwithstanding the foregoing, under the Exchange Act, all Alternative Investment Funds are prohibited from employing, in connection with the purchase or sale of any security registered or unregistered on a national securities exchange, any manipulative or deceptive device or contrivance in contravention of the rules and regulations that the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors.

In furtherance of the foregoing, the SEC enacted Rule 10b-5 which states that it is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails or any facility of any national securities exchange, (i) to employ any device, scheme or artifice to defraud, (ii) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (iii) to engage in any act, practice or course of business which operates or would operate as fraud or deceit upon any person.

4.2 Are there any limitations on the types of investments that can be included in an Alternative Investment Fund's portfolio whether for diversification reasons or otherwise?

Generally, any limitations regarding the types of investments that an Alternative Investment Fund may include in its portfolio are included in the governance documents and are disclosed in the offering documents. The limitations, if any, will depend on the particular investment strategy of the Alternative Investment Fund.

However, there are a variety of federal and state laws that limit ownership in companies involved in highly regulated or sensitive industries or require extensive filings and other regulatory requirements in order to acquire an ownership stake. For example, there are certain regulatory burdens related to the acquisition of ownership stakes beyond certain thresholds in the banking, financial services and insurance industries, in public utilities and transportation industries (such as airlines and railroads), and in the defence industry.

In addition, the ICA places certain limits on the investments that an Alternative Investment Fund may make in registered investment companies. Particularly, under Section 12(d)(1)(A)(i) of the ICA, it is unlawful for an Alternative Investment Fund to acquire any security issued by a registered investment company if after the acquisition the Alternative Investment Fund owns more than 3% of the total outstanding voting stock of the registered investment company. Although there are other investment limitations under Section 12(d) related to registered investment companies, they are not currently applicable to Alternative Investment Funds that are exempt from the provisions of the ICA under Sections 3(c)(1) and 3(c)(7) of the ICA.

Furthermore, Alternative Investment Funds should take into consideration antitrust concerns if a transaction in which they are engaging is subject to the Hart-Scott-Rodino Antitrust Improvements Act of 1976 and/or the Puerto Rico Monopoly Act and certain restrictions related to short-selling of securities under the rules and regulations promulgated under the Exchange Act, such as Regulation SHO and Regulation M.

4.3 Are there any restrictions on borrowing by the Alternative Investment Fund?

No. There are no statutory restrictions with respect to borrowings or leverage by Alternative Investment Funds. However, it is common to see in Alternative Investment Funds' governing documents clauses that limit the amount of leverage that the Alternative Investment Fund may use. If the Alternative Investment Fund is authorised to use leverage and expects to use it in its investment strategy, it should clearly disclose said fact and explain to potential investors the risks involved in the use of leverage.

5 Disclosure of Information

5.1 What public disclosure must the Alternative Investment Fund make?

Federal Public Disclosures

Under the Advisers Act, Investment Advisers registering with the SEC must complete Form ADV, or certain parts of Form ADV, if the Investment Adviser is an Exempt Reporting Adviser. Form ADV is available to the public via the Investment Adviser Public Disclosure website administered by the SEC.

Also, Investment Advisers with assets in excess of USD 150 million must file Form PF with the SEC. Form PF requires the Investment Adviser to disclose certain information related to the Funds that they advise, including, without limitation, information regarding size, leverage, investor types, geographical concentration of investments, fund strategy, fund performance, and liquidity. The types and extent of the information that needs to be disclosed will depend on the amount of AUM and the type of Funds that the Investment Adviser manages. For example, Form PF requires the disclosure of different information if the Fund is a Hedge Fund, as opposed to a Private Equity Fund.

All issuers that rely on Regulation D of the Securities Act to offer their securities must file Form D with the SEC, which is publicly available via the SEC's EDGAR system. Form D must be filed within 15 days of the first sale of the Alternative Investment Fund securities and must be amended annually for as long as the Alternative Investment Fund offers securities.

Puerto Rico Public Disclosures

All Investment Advisers doing business in Puerto Rico are required to complete and file Form ADV and notify OCFI of its filing. This requirement applies whether the Investment Adviser is registering with the SEC, registering with OCFI as a "state-registered" adviser or if it is filing as an "Exempt Reporting Adviser".

Although Investment Advisers registering as "state-registered" advisers with OCFI must complete and file a series of additional forms, only Form ADV is generally available to the public.

Under PRUSA, an issuer that relies on Regulation D to offer and sell securities in Puerto Rico must send a notification to OCFI with a copy of the Form D filed with the SEC, a notification payment fee and their consent to the service of process.

Under the PR Corporations Act, each entity organised in Puerto Rico or authorised to do business in Puerto Rico must make certain filings with the Puerto Rico Department of State that are available to the public. Similarly to Delaware, only entities organised as Corporations are required to file annual reports. Further, LLCs and LPs are not required to file annual reports as they are only required to make an annual fee payment.

5.2 What are the reporting requirements in relation to Alternative Investment Funds?

Please refer to our response in question 5.1 above.

5.3 Is the use of side letters restricted?

No. The use of side letters is not restricted. An Alternative Investment Fund should disclose in its offering documents that it may enter into side letters with investors that might have different terms and conditions to those disclosed in the offering documents. Furthermore, Investment Advisers should always take into consideration their fiduciary obligations under the Alternative Investment Fund and its beneficial owners when negotiating side letters with other investors.

6 Taxation

6.1 What is the tax treatment of the principal forms of Alternative Investment Funds?

As a general rule, LLCs organised in Puerto Rico are taxed as corporations. However, the PR IRC allows LLCs to elect to be treated as partnerships for income tax purposes, even if the LLC has only one member. The PR IRC currently does not provide for entities to be taxed as disregarded entities. As with tax elections made pursuant to the IRC, the election to be taxed as a partnership under the PR IRC allows Funds to be transparent for Puerto Rico tax purposes, making the members the parties responsible for the tax liability instead of the Fund. Furthermore, the PR IRC provides that every LLC that by reason of its election or provision of law or regulation under the IRC, or similar provision of a foreign country, is treated as a partnership, or whose income and expenses are attributed to its members for federal income tax purposes or that of the foreign country, shall be treated as a partnership for purposes of the PR IRC, and shall not be eligible to be taxed as a corporation.

6.2 What is the tax treatment of the principal forms of investment manager / adviser?

As a general rule, a Puerto Rico Investment Adviser elects to be taxed as a partnership under the PR IRC. As mentioned above, entities organised in Puerto Rico or that are authorised to do business in Puerto Rico do not have available the option of being treated as a disregarded entity. Notwithstanding the above, certain investment managers elect to keep the default corporation tax treatment in order to utilise certain income tax deferrals, simplify tax compliance requirements and possibly maximise benefits under certain tax incentives acts (discussed below).

With the enactment of Act No. 20 of January 17, 2012, as amended ("**Act 20**"), certain Investment Advisers organised in Puerto Rico or who establish operations in Puerto Rico that provide advice to Funds located outside of Puerto Rico or to other Investment Advisers located outside of Puerto Rico (i.e. export their services) are electing to be to be taxed as corporations to benefit from the interplay of

Section 933 of the IRC and Act 20, which provides a preferential tax rate of 4% for services rendered from Puerto Rico to persons located outside of Puerto Rico, such as Funds, other Investment Advisers or investors. In addition, Act 20 provides a 0% rate on dividends distributed by the entity to its owners from income derived from export activities. Please note that Act 20 requires grantees to have at least three full-time (or full-time equivalent) employees within the first six months from the commencement of operations and five employees within two years after commencement of operations.

The terms of the exemption provided to the entity under Act 20 are gathered in a Tax Grant, which is considered a contract between the government of Puerto Rico and the entity that requested the benefits. The initial term of an Act 20 Tax Grant is 20 years and can be extended for an additional 10 years.

6.3 Are there any establishment or transfer taxes levied in connection with an investor's participation in an Alternative Investment Fund or the transfer of the investor's interest?

The PR IRC does not provide a specific transfer tax on the transfer of an investor's ownership interest in the Alternative Investment Fund. As with the IRC, the PR IRC imposes a capital gains tax on the sale of appreciated ownership interest in the Fund. If the Fund elects to be taxed as a partnership, as with the IRC, the PR IRC provides that the tax liability on the income received by the Fund will flow through to the members and they will be responsible for any tax liability determined under the PR IRC.

Notwithstanding, the Puerto Rico government enacted Act No. 22 of January 17, 2012, as amended ("**Act 22**"), which provides an exemption from Puerto Rico sourced passive income. This includes capital gains, interest and dividends. Act 22 ties into both the IRC exemption for a *bona fide* resident to not be subject to federal taxation on Puerto Rico sourced income and the sourcing rules of the IRC. Therefore, for example, an individual that receives interest income from an investment in a Fund located in Puerto Rico would be exempt from Puerto Rico and federal taxes. By the same token, given that capital gains are sourced to the residence of the seller and, in the case of partnership, are determined at the level of the partners, investors can greatly benefit from the interplay of the above rules.

Furthermore, an individual who owns an Investment Adviser which has an Act 20 Tax Grant (as discussed above), and which provides services to an Alternative Investment Fund or to another Investment Adviser located outside of Puerto Rico, can receive dividend distributions subject to a 0% tax rate.

To benefit from Act 22, individuals must become *bona fide* residents of Puerto Rico and they must not have been residents of Puerto Rico between 2006 and 2012.

6.4 What is the tax treatment of (a) resident, (b) non-resident, and (c) pension fund investors in Alternative Investment Funds?

Puerto Rico born individuals are also United States citizens. As such, they are subject to taxation on their worldwide income, under both the IRC and the PR IRC. To determine the tax treatment that may apply to (a) residents, (b) non-residents, and (c) pension fund investors, it is required to examine their treatment under both the IRC and the PR IRC. In addition, as mentioned above, *bona fide* residents of Puerto Rico can exclude from federal and state taxation any income that is treated as Puerto Rico sourced, pursuant to the exclusion of Section 933 of the IRC. To be considered a *bona fide* resident of Puerto Rico, the individual must comply with three (3) residency tests during the tax year in which they received the income. The three (3) tests are: (i) physical presence; (ii) tax home; and (iii) closer connection. If the individual complies with all three (3) tests and receives Puerto Rico sourced income, they can exclude said income from federal and state taxation. *Bona fide* individuals are subject to the taxes imposed by the PR IRC. The tax rates that apply vary depending on the type of income and amount of income received. Tax rates vary from 0% to 33% for individuals, and from 20% to 39% for corporations.

Non-residents that derive Puerto Rico sourced income are subject to the PR IRC. As with residents, the tax rates that apply to non-residents vary depending on the amount and type of income received by the non-resident. In the case of non-residents that are not engaged in a trade or business in Puerto Rico and derive Puerto Rico sourced income, as a general rule, they are subject to a 29% withholding at source.

Entities organised in Puerto Rico are considered foreign entities for purposes of the IRC and can also use the exclusion of income provided by Section 933 of the IRC. As with individuals that are residents of Puerto Rico and engaged in a trade or business, entities are subject to the PR IRC and the tax rates vary depending on the type of income. The PR IRC tax rates for entities range from 20% up to 39%. In the case of entities that are not engaged in a trade or business that derive Puerto Rico sourced income, they are subject to a 39% withholding tax.

6.5 Is it necessary or advisable to obtain a tax ruling from the tax or regulatory authorities prior to establishing an Alternative Investment Fund?

It is not required to request a tax ruling from the Puerto Rico Treasury Department prior to the establishment of an Alternative Investment Fund.

6.6 What steps have been or are being taken to implement the US Foreign Account and Tax Compliance Act 2010 (FATCA) and other similar information reporting regimes such as the Common Reporting Standard?

Puerto Rico is subject to the Foreign Account and Tax Compliance Act 2010.

6.7 Are there any other material tax issues?

There are none.

6.8 What steps are being taken to implement the OECD's Action Plan on Base Erosion and Profit-Shifting (BEPS), in particular Actions 6 and 7, insofar as they affect Alternative Investment Funds' operations?

As of this date, Puerto Rico has not adopted the OECD's Action Plan on Base Erosion and Profit-Shifting (BEPS).

7 Reforms

7.1 What reforms (if any) are proposed?

On the local front, the Puerto Rico Legislature will propose to the United States Congress an amendment to the Foreign Assistance Act of 1961 in order to authorise the Overseas Private Investment

Corporation to facilitate financing, risk insurance and support Private Equity Funds to invest in Puerto Rico. If the aforementioned amendment becomes law, it could provide a boost to local Private Equity Funds and to the business sector. As of March 31, 2017, there are no other local proposed reforms that may have a material impact on the regime governing Alternative Investment Funds.

Please note that at the federal level, the Trump administration has stated its intentions to scale back the financial regulations enacted under the Obama administration, particularly those enacted under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**"). It is also worth noting that President Trump has expressed that the preferential tax treatment applicable to "carried interest" could be changed so that it is classified as "ordinary income" or subject to a higher tax rate than the current rate of 15%. As of April 2017, we are not able to provide further guidance regarding the scope of deregulation initiatives or what will be the ultimate treatment of "carried interest" under the tax legislation overhaul being considered by the Trump administration.

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