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The Current State of U.S. Public Cryptocurrency Funds


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Introduction

One of the many plotlines shaping the emerging cryptocurrency[1] story involves repeated attempts by fund sponsors to bring exchange-traded cryptocurrency-related funds ("**cryptocurrency ETFs**") to the U.S. investing public. No such sponsor has succeeded to date. Proponents of such funds, on the one hand, argue that these products would: (1) improve the existing means by which retail investors obtain exposure to cryptocurrencies (for example, by simplifying asset acquisition and custody); and (2) provide structural benefits to the existing cryptocurrency markets (for example, by deepening the pool of available liquidity). The U.S. Securities and Exchange Commission ("**SEC**"), on the other hand, continues to express a number of concerns – primarily, questions involving the integrity of the cryptocurrency spot market, including the online exchanges where such assets trade. This chapter will describe the general features of the cryptocurrency ETFs that the SEC has so far considered, along with the SEC's principal reasons for declining to approve any such funds. Finally, it will consider what 2020 may hold in store for these products, including the industry's efforts to improve the public perception of the cryptocurrency spot markets.

A Tight Spot and Murky Futures

In 2018 and 2019, the SEC considered rule change applications[2] that would allow for cryptocurrency ETFs of two different varieties: (1) funds intending to transact in the cryptocurrency spot market and to hold cryptocurrencies directly ("**spot position-based ETFs**"); and (2) funds intending to gain cryptocurrency exposure through futures ("**futures-based ETFs**"). Further, futures-based ETFs can be divided into long funds, which seek to mirror the performance, both daily and over time, of leading Bitcoin futures contracts listed and traded on regulated U.S. national futures exchanges, and short funds, which seek to do the opposite. The proposed futures-based ETFs only pertain to Bitcoin for the moment, as no other cryptocurrencies are the subject of futures contracts in a regulated U.S. market.[3] Additionally, most proposed spot position-based ETFs have also focused solely on Bitcoin, although at least one proposed spot position-based ETF intended to invest in a basket of cryptocurrencies.

The SEC and its staff, in declining to approve any such ETF – whether spot position-based or futures-based – have primarily cited concerns around the cryptocurrency spot market, including the online exchanges where such assets trade. The SEC has focused on this because the market price for the ETF shares will be heavily influenced by trading activity in the lightly regulated, underlying cryptocurrency spot markets. In particular, the arbitrage mechanism underlying all ETFs causes their share price to be particularly sensitive to changes in the price of the underlying assets. This arbitrage mechanism – effected through the in-kind creation and redemption process undertaken by authorised participants – is intended to ensure that an ETF's share price closely tracks the ETF's net asset value per share ("**NAV**"). For example, if the ETF's shares are trading at a premium to NAV, authorised participants will create new shares at NAV ("**creation units**") and sell them on the open market. If the fund's shares are trading at a discount to NAV, authorised participants will buy shares on the open market and redeem them at NAV. This mechanism generally works well to keep ETF shares in line with NAV, but makes the integrity of an ETF's share price vulnerable to issues in the markets for the underlying asset (and, in the case of a futures-based ETF, the assets underlying the futures contracts in the ETF's portfolio).

In that regard, the SEC and its staff have noted that the low liquidity of cryptocurrency exchanges could inhibit an ETF's arbitrage mechanism by limiting the ability of authorised participants to obtain sufficient quantities of the underlying asset to support creation transactions without affecting the underlying market price. The SEC also noted that less liquid markets are more susceptible to manipulation and that, moreover, much of the volume in cryptocurrency trading occurs outside the United States in venues that are suspected to experience significant manipulation. The SEC thus raised concerns that manipulation in spot markets could, ultimately, adversely affect the integrity of the price of an ETF's shares or even permit the shares themselves to be manipulated. In addition, the SEC and its staff noted that cybersecurity, theft, hacking and operational issues, which have plagued cryptocurrency exchanges, could also inhibit the operation of a cryptocurrency ETF, such as by reducing liquidity or permitting price manipulation.

Unfortunately for the ETF industry, the recent history of cryptocurrency exchanges offers several examples from which the SEC can draw to support its concerns. Over the past several years, a number of cryptocurrency exchanges have been closed due to cybersecurity breaches and theft, in amounts totalling over $1 billion (USD). For instance, the now infamous Mt. Gox exchange filed for bankruptcy in 2014, claiming $63.6 million (USD) of outstanding debt, in connection with losing 750,000 of its customers' Bitcoins, along with 100,000 of its own.[4]

Additionally, in early 2019, one of the largest Canadian exchanges was unable to retrieve at least $190 million (USD) worth of customer funds.[5] After the mysterious death of its founder, customers quickly learned that this individual had the sole power to authorise movement of customer funds – fiat and cryptocurrency alike. While an investigation is currently ongoing, this episode highlights the lack of appropriate operational risk

management in some cryptocurrency exchanges, even large exchanges located in countries with robust financial regulatory systems.[6]

Furthermore, in late 2017, an anonymous blogger cited publicly available trading data to conclude that a trading bot, aptly nicknamed "Picasso", was engaging in paint-the-tape-style manipulation on one of the largest and most prominent U.S. exchanges.[7] This strategy involved the alleged buying and selling of Bitcoin and Bitcoin Cash between affiliated accounts in order to create the appearance of substantial trading activity and, ultimately, to influence the price of such assets. Other reports of manipulative practices include so-called "banging the close"[8] and "spoofing"[9] and have been the subject of a high-profile criminal investigation by the U.S. Department of Justice.[10]

More broadly, these episodes illustrate the SEC's general observation that no cryptocurrency spot market, whether in the United States or abroad, is subject to governmental oversight on par with U.S. national securities exchanges, which are held to high cybersecurity and operations standards, and are required to take steps to detect and deter price manipulation and fraud. For example, the SEC rejected arguments that Gemini Exchange was a sufficiently regulated market simply by virtue of its New York State trust charter and supervision by New York's Department of Financial Services.

While it is too early to anticipate what effect they will have in the near term, several trends may help the industry overcome the SEC's concerns with the state of the spot markets. First, not all SEC commissioners are convinced that the market issues are so grave that they should prevent the launch of a cryptocurrency ETF. In particular, Commissioner Peirce made waves with her dissent from the SEC's order disapproving the listing of one such fund, arguing that such disapprovals effectively preclude greater institutionalisation of cryptocurrency markets, and accordingly, raise even greater investor protection concerns.[11] Consider, for example, price fragmentation – i.e., the tendency for cryptocurrencies to vary in price, from time to time, across different exchanges. Commissioner Peirce notes that authorised participants would minimise fragmentation because, in the process of composing creation units, such participants could obtain cryptocurrency from any source. Because authorised participants have an incentive to buy at the lowest prices available, such authorised participants would effectively keep prices close together by "bidding up" the price on certain exchanges where the price started to diverge downward from the market.

Second, industry participants have joined forces in an effort to allay concerns of the SEC and the broader market related to issues of market integrity. For example, in November 2018, several large cryptocurrency companies – including prominent exchanges, OTC dealers and investment and trading firms – announced the formation of the Association for Digital Asset Markets ("**ADAM**").[12] ADAM's stated goal is to provide a framework for self-regulation in the cryptocurrency spot market, in the form of a Code of Conduct, which would deter market manipulation and promote market integrity, risk management and data protection, among other things. Eventually, ADAM could take on a more active self-regulatory-type role within the industry (e.g., by resolving disputes, disciplining members and promulgating licences).

Third, well-established and trusted financial services companies are beginning to offer custody solutions, which include robust security procedures and large insurance policies. For example, in 2019, Fidelity Investments launched Fidelity Digital Asset Services ("**FDAS**"), a full-service enterprise-grade platform for securing, trading and supporting digital assets, such as Bitcoin.[13] On November 19, 2019, the New York State Department of Financial Services (the "**NYDFS**") announced that it had granted FDAS a charter under New York banking law to operate as a limited liability trust company.[14]

Finally, fund sponsors continue to engage in rigorous, substantive discussions with the SEC and its staff. For instance, in October 2019, the SEC issued an order disapproving the proposed Bitwise Bitcoin ETF rule change, noting that the proposal for this spot position-based ETF, which had been filed with NYSE Arca in January 2019, fell short of meeting the legal requirements to prevent market manipulation and other illicit activities.[15] This order was largely consistent with the SEC's prior rejections; however, the 112-page order was distinguishable from previous denials for several reasons. First, the denial shows that measurable progress has been made in the eyes of the SEC and its staff since the Winklevoss Bitcoin Trust denial in 2018. For example, sponsors have realised and responded to the fact that the SEC staff tended to: (1) disfavour pricing mechanisms that rely on a single exchange, due to the risk that a public cryptocurrency fund would overwhelm that market; and (2) favour the use of surveillance-sharing agreements with regulated markets of significant size. Bitwise sought to address these concerns by proposing a pricing mechanism based on a small set of identified spot market venues that have "real" trading volume.[16] Nonetheless, the SEC's denial indicated that the current data is insufficient; it needs more data on where price discovery occurs and, possibly, surveillance-sharing agreements with underlying spot market trading venues. One continuing hurdle which sponsors must contend with is the fact that two of the largest Bitcoin trading venues are largely outside of the jurisdiction of U.S. regulators: (1) Binance, the largest Bitcoin spot market, which is based in Malta and is not registered with FinCEN or the NYDFS; and (2) BitMEX, the largest synthetic market for Bitcoin, which is based in the Seychelles and has been the subject of ongoing investigation by the CFTC.[17]

The lead-in to 2020 has seen SEC staff apparently willing to engage with fund innovation in this area, as evidenced by the SEC's approval of the NYDIG Bitcoin Strategy Fund (the "**NYDIG Bitcoin Fund**"), a registered closed-end interval fund launched by Stone Ridge Asset Management that invests in cash-settled Bitcoin futures contracts traded on CFTC-registered exchanges, which is offered to institutional investors and their clients.[18] Dalia Blass, Director of the SEC's Division of Investment Management, referenced the NYDIG Bitcoin Fund's registration in a keynote speech at the Investment Company Institute's Securities Law Developments Conference in December 2019, where she addressed the topic of fund innovation.

Director Blass noted that the risks presented by the digital asset markets have been sufficiently mitigated by the NYDIG Bitcoin Fund because: (1) the fund generally values its Bitcoin futures holdings at daily settlement prices reflected on a CFTC-registered exchange, consistent with the principles of the Investment Company Act of 1940 and U.S. generally accepted accounting principles; (2) the fund invests in cash-settled futures, so it does not present the custody challenges associated with direct holdings of digital assets; (3) the fund is a closed-end interval fund, so it does not offer daily redemptions and thus is not subject to potentially large, unexpected liquidity demands over short periods; (4) the fund is an unlisted fund, so its pricing does not depend on an efficient arbitrage mechanism and the willingness of market makers to make markets in a fund pursuing a digital asset strategy; and (5) the fund has implemented certain limitations on the offering, such as instituting an initial $25 million cap and offering only to clients of professional investment advisers.

Additional Core Concerns

The SEC's disapprovals throughout 2018 and 2019 of various proposed cryptocurrency ETFs, as described above, were foreshadowed by the January 2018 letter from Director Blass. This letter was addressed to industry sponsors and pertained to cryptocurrency ETFs, both ETFs and public, non-exchange-traded funds, and offered a list of questions that sponsors would be expected to address when attempting to bring these products to market. In particular, in addition to the manipulation concerns cited by the SEC in its disapproval orders, the letter highlighted the apprehensions of SEC staff about valuation, liquidity, custody and arbitrage.

A. Valuation

The letter first addressed staff concerns about valuation challenges in calculating cryptocurrency ETFs' NAV. In general, public mutual funds and ETFs in the United States are required to value their assets each business day to calculate an NAV. This is important for determining fund performance and the price at which investors may purchase or redeem shares. In particular, SEC staff expressed concerns about whether cryptocurrency ETFs would have the information necessary to appropriately value cryptocurrencies, given their volatility, the fragmentation and general lack of regulation of underlying cryptocurrency markets and the nascent state of and current trading volume in the cryptocurrency futures markets.[19] SEC staff also questioned how and which policies would be instituted in order to properly establish the "fair value" of a cryptocurrency fund's portfolio. For instance, SEC staff expressed concern over how funds' valuation and accounting policies might be designed to address cryptocurrency-specific risks, such as when a blockchain diverges into different paths (a "**fork**"), which can produce different cryptocurrencies with differing prices, and how this possibility would be recognised in the fund's NAV.

B. Liquidity

The letter next discussed staff concerns about liquidity – specifically, the importance of funds maintaining sufficient liquidity such that daily redemptions would be possible, given that an essential feature of most U.S. ETFs, and other public open-end funds, is daily redeemability. SEC staff also expressed doubt over digital currency funds' ability to adhere to fund liquidity requirements, which generally necessitate that most types of U.S. ETFs and other public open-end funds implement a liquidity risk management programme, to be able to classify investments into one of four categories and limit the fund's investments in illiquid securities to 15% of the fund's total assets.

C. Custody

The letter also raised staff concerns relating to requirements applicable to certain U.S. public funds, particularly regarding custody of their holdings, and inquired as to how funds that planned to directly hold cryptocurrencies would satisfy such custody requirements. The letter asked these questions in light of the underlying novel technical aspects of cryptocurrencies and related cybersecurity threats, as well as in connection with funds that plan to hold public cryptocurrency derivatives.

D. Arbitrage

Next, the letter discussed SEC staff concerns related to how well a cryptocurrency ETF's arbitrage mechanism would be able to function in light of the fragmentation, volatility and trading volume of the cryptocurrency marketplace. As discussed above, an ETF's arbitrage mechanism is the fundamental means by which the market price of the ETF's shares is kept in line with its NAV. SEC staff inquired whether cryptocurrency ETF sponsors had engaged with market makers and authorised participants in order to understand the feasibility of arbitrage in relation to cryptocurrency ETFs.

Conclusion

Given the SEC's persisting qualms, no sponsor of either a spot position-based ETF or futures-based ETF has succeeded yet in convincing the SEC to let it offer cryptocurrency ETFs to U.S. retail investors. We do not expect, however, that sponsors will be deterred from continuing to push for cryptocurrency ETFs in the United States in 2020. As the underlying spot markets mature, sponsors' chances for success will improve, although whether success will be achieved this year remains to be seen. At the end of 2018, SEC Chairman Jay Clayton had noted, "[w]hat investors expect is that the trading in that commodity that's underlying the ETF is trading that makes sense, is free from the risk or significant risk of manipulation". He continued, "[t]hose kinds of safeguards don't exist in many of the markets where digital currencies trade", making it unlikely, he said, that the SEC will approve a Bitcoin ETF in the near future.[20] Over the course of 2019, however, ETF sponsors made continued headway in their conversations with the SEC, as illustrated by the Bitwise example above. At the same time, the SEC has demonstrated a willingness to engage in fund innovation in this area, as illustrated by the NYDIG Bitcoin Fund, provided that the appropriate investor safeguards are in place. These developments lead to cautious optimism for a path forward for cryptocurrency ETFs.

Endnotes

1. In this chapter, "cryptocurrency" is used to refer to all decentralised digital assets, whether they are intended to be used in a currency-like manner (e.g., Bitcoin), or as part of a larger platform (e.g., Ethereum). In addition to pure cryptocurrencies and privacy-focused coins, the broad range of general-purpose digital assets ("**platform coins**") includes NEO and Ravencoin, for instance. These platform coins also enable the creation of new digital assets called "tokens", that are usually developed for a particular purpose or application.
2. Generic listing rules currently do not permit any national exchange (e.g., NYSE Arca, NASDAQ or Cboe) to allow trading in cryptocurrency ETFs. Consequently, the listing exchange must submit, and the SEC must approve, a listing rule specifically allowing such a fund. Such applications are generally made pursuant to Rule 19b-4 under the Securities Exchange Act of 1934, as amended ("**Exchange Act**"), which: (1) requires public notice and comment; and (2) provides that the SEC must make specific findings that the rule change would be consistent with the Exchange Act's policy goals. *See*, e.g., Exchange Act Release No. 79183 (Oct. 28, 2016), 81 FR 76650 (Nov. 3, 2016) (amending, and replacing, original rule filing in its entirety); Exchange Act Release No. 34-83792, File No. SR-CboeBZX-2018-040 (Aug. 7, 2018); Exchange Act Release No. 34-83912, File No. SR-NYSEArca-2018-02 (Aug. 22, 2018).

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7. *See* Bitfinex'ed, Meet 'Picasso', the Painter on GDAX, *Medium.com* (2017), https://medium.com/@bitfinexed/meet-picasso-the-painter-on-gdax-c478ff8f50e5 (last visited Jan. 4, 2019).
8. "Banging the close" is a type of Bitcoin futures manipulation strategy in which the price of Bitcoin is pushed either higher or lower when the futures contract expires and which is easiest to execute if there are small numbers of participants in an auction. *See* Alexander Osipovich, Bitcoin Futures Manipulation 101: How 'Banging the Close' Works, *The Wall Street Journal* (2017), https://www.wsj.com/articles/bitcoin-futures-manipulation-101-how-banging-the-close-works-1513425600/ (last visited Feb. 2, 2019).
9. "Spoofing" is an illicit tactic whereby a trader submits a series of orders and then cancels them as soon as prices move in the desired direction. *See* Matt Robinson & Tom Schoenberg, U.S. Launches Criminal Probe into Bitcoin Price Manipulation, *Bloomberg.com* (2018), https://www.bloomberg.com/news/articles/2018-05-24/bitcoin-manipulation-is-said-to-be-focus-of-u-s-criminal-probe (last visited Feb. 2, 2019).
10. Robinson, M. and Schoenberg, T., U.S. Launches Criminal Probe into Bitcoin Price Manipulation, *Bloomberg.com* (2018), (last visited Dec. 23, 2019).
11. *See* Dissent of Commissioner Hester M. Peirce to Release No. 34-83723; File No. SR-BatsBZX-2016-30 (2018), https://www.sec.gov/news/public-statement/peirce-dissent-34-83723 (last visited Jan. 10, 2019).
12. Association for Digital Asset Markets, ADAM: Vision and Founding Principles – Association for Digital Asset Markets, *Medium.com*, (2018), https://medium.com/AssociationDigitalAssetMarkets/adam-vision-and-founding-principles-be98f97aa42a (last visited Feb 2, 2019). *See also* Cameron Winklevoss & Tyler Winklevoss, A Proposal for a Self-Regulatory Organization for the U.S. Virtual Currency Industry, *Medium.com* (2018), https://medium.com/gemini/a-proposal-for-a-self-regulatory-organization-for-the-u-s-virtual-currency-industry-79e4d-7891cfc (last visited Feb. 2, 2019) (describing Gemini's efforts to introduce greater oversight and self-regulatory mechanisms into the virtual currency industry through the creation of the Virtual Commodity Association, an industry-sponsored, self-regulatory organisation for the U.S. virtual currency industry pertaining specifically to virtual commodity exchanges and custodians).
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15. U.S. Securities and Exchange Commission, Release No. 34-87267; File No. SR-NYSEArca-2019-01 (2019), https://www.sec.gov/rules/sro/nysearca/2019/34-87267.pdf (last visited Dec. 31, 2019).
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1 Registration

1.1 Are funds that are offered to the public required to be registered under the securities laws of your jurisdiction? If so, what are the factors and criteria that determine whether a fund is required to be registered?

A fund that is offered publicly in the U.S. must register under the U.S. Investment Company Act of 1940 (the "**1940 Act**") if the fund is organised under U.S. law and is an "investment company" as defined under the 1940 Act. Under Section 3(a)(1)(A) of the 1940 Act, an "investment company" is defined as any issuer that is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities. Section 3(a)(1)(A) is a subjective test designed to capture issuers that hold themselves out to the public as traditional funds, primarily engaged in the business of investing in securities. Additionally, the definition of "investment company" also includes an objective, numerical test designed to capture other types of issuers that may own significant amounts of investment securities, even if such issuers do not hold themselves out to the public as traditional funds. The objective, numerical test under Section 3(a)(1)(C) of the 1940 Act defines an "investment company" as any issuer that is engaged or proposes to engage in the business of investing, reinvesting, owning, holding or trading in securities and owns or proposes to acquire "investment securities" having a value exceeding 40% of the issuer's total assets (exclusive of U.S. government securities and cash items) on an unconsolidated basis. For these purposes, "investment securities" includes all securities except U.S. government securities, cash items and securities issued by majority-owned subsidiaries which do not themselves fall within the definition of "investment company" under the 1940 Act.

A fund that is organised under the laws of a jurisdiction outside the U.S. would not be permitted to register under the 1940 Act, even if it fell within the 1940 Act definition of "investment company". Thus, as further discussed in question 1.4 below, a non-U.S. fund that is an "investment company" as defined under the 1940 Act would be prohibited from conducting a public securities offering in the U.S., unless it: (a) is eligible for an exemption from 1940 Act registration requirements; or (b) applies for and obtains an order from the U.S. Securities and Exchange Commission (the "**SEC**") permitting such non-U.S. fund to register under the 1940 Act and conduct a public offering in the U.S. A number of exemptions are available under the 1940 Act for certain types of issuers, such as banks, insurance companies, broker-dealers, finance subsidiaries, commercial financing and mortgage banking businesses. An issuer that qualifies for one of these exemptions would be permitted to offer its securities publicly in the U.S. without registering under the 1940 Act, whether such issuer is organised under U.S. law or the laws of a non-U.S. jurisdiction. However, non-U.S. funds are unlikely to qualify for one of these exemptions, which are intended to exempt certain types of financial services businesses, and do not exempt funds that are primarily engaged in the business of investing in securities. Non-U.S. funds are also unlikely to be granted an order from the SEC permitting it to register under the 1940 Act and conduct a public securities offering in the U.S. Under Section 7(d) of the 1940 Act, the SEC is authorised to grant such an order if the SEC finds that "it is both legally and practically feasible effectively to enforce the provision of the [1940 Act] against the company, and further finds that granting the application is otherwise consistent with the public interest and the protection of investors". This standard is often difficult to meet because the regulatory frameworks applicable to funds outside the U.S. differ significantly from the 1940 Act. For these reasons, non-U.S. funds generally can only be offered in the U.S. on a private basis, as discussed in further detail in question 1.4 below.

1.2 What does the fund registration process involve, e.g., what documents are required to be filed?

A U.S. fund may initiate registration under the 1940 Act by filing a notification of registration on Form N-8A. Within three months after filing its Form N-8A, the fund is required to file a registration statement that describes, among other things, the fund's investment objectives, principal investment risks, fees, performance and management, and the fund's policies with respect to borrowing money, issuing senior securities, underwriting securities issued by others, investment concentrations, purchase and sale of real estate and commodities, making loans and portfolio turnover. A fund's registration statement contains its Prospectus and Statement of Additional Information, and must be filed with certain other documents attached as exhibits, such as the fund's Articles of Incorporation and By-Laws, investment advisory agreements, custodian agreements, transfer agency agreements and other material agreements entered into by the fund. The form that is required to be used for the registration statement will depend on the type of fund that is being registered. For example, open-end funds that issue redeemable shares, such as mutual funds, register on Form N-1A, and closed-end funds that issue non-redeemable shares register on Form N-2. Registration fees are also required to be paid to the SEC in connection with a fund's registration, in the case of closed-end funds, prior to the effective date of the registration statement, and in the case of open-end funds, within 90 days after the end of the fund's fiscal year, based on the amount of securities sold and redeemed during such fiscal year.

Filings with the SEC must be done electronically on the SEC's Electronic Data Gathering and Retrieval System ("**EDGAR**"). After a registration statement is filed with the SEC on EDGAR, the SEC staff will review the registration statement and provide initial written comments, typically within 30 days of the EDGAR filing. The review process may involve several rounds of comments and exchanges with SEC staff, until all of the SEC staff's comments are resolved and the registration statement is declared effective. Typically, the review process will take at least 90 days or longer, depending on the nature of the SEC staff's comments. A fund may not make a public offering of its securities in the U.S. until its registration statement is effective.

1.3 What are the consequences for failing to register a fund that is required to be registered in your jurisdiction?

There are severe consequences for funds that fail to comply with the registration requirements under the 1940 Act. Section 47 of the 1940 Act states that contracts made in violation of the 1940 Act or the rules thereunder are unenforceable by either party, unless a court finds that enforcing such contracts would produce a more equitable result and would not be inconsistent with the 1940 Act's purposes. For example, under Section 7(a) of the 1940 Act, a U.S. fund that is required to register under the 1940 Act is prohibited from selling its securities publicly in the U.S. unless it is registered. If such fund conducts a public offering of its securities in the U.S. without having first registered under the 1940 Act, the sale of its securities would be in violation of Section 7(a) of the 1940 Act, and therefore voidable under Section 47 of the 1940 Act. Buyers of the fund's securities in such case would theoretically have an option to rescind their purchase of the fund's securities. Underwriters and other counterparties may also be unwilling to enter into underwriting or other agreements with such fund because of the risk that the indemnification provisions and other undertakings would be unenforceable against the fund.

For a non-U.S. fund, which as discussed above is not permitted to register under the 1940 Act, activities in the U.S. will be limited unless such non-U.S. fund qualifies for and complies with the requirements of an exemption under the 1940 Act. For example, most U.S. lenders require a legal opinion that the borrower is not required to register under the 1940 Act, and that the loan agreement is valid and enforceable against the borrower. If a non-U.S. fund does not qualify for or comply with an exemption under the 1940 Act, it may be unable to obtain such a legal opinion, and could have difficulty borrowing money in the U.S.

In addition, there are monetary fines and criminal penalties for knowing violations of the 1940 Act.

1.4 Are there local residency or other local qualification requirements that a fund must meet in order to register in your jurisdiction? Or are foreign funds permitted to register in your jurisdiction?

A fund must be organised under U.S. law in order to be eligible to register under the 1940 Act. A fund organised outside the U.S. is not permitted to register under the 1940 Act and, under Section 7(d) of the 1940 Act, is generally prohibited from making a public offering of securities in the U.S. using "interstate commerce" as defined in Section 2(a)(18) of the 1940 Act (i.e., using trade, commerce, transportation or communication among the several states or possessions of the U.S., or between any such state or possession of the U.S. and any foreign country, place or ship outside of the U.S.). A non-U.S. fund therefore can only offer its securities publicly in the U.S. if it qualifies for an exemption, or applies for and obtains an SEC order. As discussed in question 1.1 above, non-U.S. funds generally are not likely to qualify for an exemption or SEC order allowing them to offer their securities publicly in the U.S. Thus, although non-U.S. funds may make public offerings outside the U.S., such non-U.S. funds typically only offer securities in the U.S. on a private basis, relying on the private fund exemptions in Sections 3(c)(1) and 3(c)(7) of the 1940 Act.

Section 3(c)(1) exempts from 1940 Act registration requirements funds whose securities are not offered publicly in the U.S. and are beneficially owned by not more than 100 holders. Section 3(c)(7) exempts from 1940 Act registration requirements funds whose securities are not offered publicly in the U.S. and are beneficially owned by investors who qualify as "qualified purchasers" as defined in Section 2(a)(51) of the 1940 Act (e.g., investors who own significant investment portfolios generally with a value of at least $25 million for institutions and $5 million for individuals). In a series of no-action letters, the SEC staff applied these private fund exemptions to non-U.S. funds, and permitted non-U.S. funds to conduct a private offering of securities in the U.S. in compliance with Section 3(c)(1) or 3(c)(7) concurrently with a public offering abroad, provided that after the offerings: (a) there were no more than 100 persons resident in the U.S. who were beneficial owners of the relevant fund's securities for purposes of Section 3(c)(1); or (b) all U.S. resident owners of the relevant fund's securities were qualified purchasers for purposes of Section 3(c)(7). See, e.g., Touche, Remnant & Co., SEC No-Action Letter (Aug. 27, 1984); Goodwin, Procter & Hoar, SEC No-Action Letter (Feb. 28, 1997). In other words, the SEC staff took the position generally that non-U.S. resident shareholders of a non-U.S. fund need not be counted toward the 100-beneficial-owner limit under Section 3(c)(1), and need not be qualified purchasers when relying on Section 3(c)(7). Non-U.S. funds may not, however, rely on both Sections 3(c)(1) and 3(c)(7) for private offerings in the U.S. This is consistent with the regulation of U.S. funds, which are not permitted to rely on a combination of Sections 3(c)(1) and 3(c)(7) to be exempt from registration under the 1940 Act.

2 Regulatory Framework

2.1 What are the main regulatory restrictions and requirements that a public fund must comply with in the following areas, if any? Are there other main areas of regulation that are imposed on public funds?

i. Governance

The 1940 Act is a comprehensive regulatory regime that imposes strict requirements on funds that are registered under the Act. In addition, a special set of rules under the 1940 Act apply to money market funds, which are a type of registered fund typically used by retail and institutional investors as cash management vehicles. The 1940 Act money market fund rules are designed to promote principal stability and liquidity; for example, by imposing strict requirements regarding the credit quality, liquidity, maturity and diversification of investments made by money market funds.

For example, the 1940 Act imposes a number of requirements regarding a registered fund's corporate governance, which are intended to protect the fund's shareholders by ensuring that the fund's board is sufficiently independent, with specific oversight responsibilities, and that shareholders have the right to vote on director elections and other important matters. Section 10 of

the 1940 Act permits up to 60% of a registered fund's board of directors to consist of "interested persons" of the fund. (Under Section 2(a)(19) of the 1940 Act, "interested persons" of a registered fund is broadly defined and includes, among others: persons who have a 5% ownership in, or otherwise controls, are controlled by or under common control with, such fund; persons who are affiliated with the fund's investment adviser; persons who have acted as legal counsel to the fund; and persons who have executed portfolio transactions for, engaged in principal transactions with, or loaned money to, such fund or any other fund sharing an investment adviser with such fund.) However, most registered funds rely on certain exemptive rules under the 1940 Act which were amended by the SEC to require compliance with additional fund governance standards that are set out in Rule 0-1(a)(7) under the 1940 Act. Rule 0-1(a)(7) requires that: (a) independent directors must constitute at least 75% of the fund's board; (b) only the independent directors select and nominate any other independent director of the fund; (c) legal counsel for the independent directors must be an independent legal counsel meeting the requirements of Rule 0-1(a)(6); (d) an independent director must serve as chairman of the board; (e) the board must perform an annual evaluation of itself and its committees; (f) the independent directors must meet at least quarterly in a session at which no directors who are interested persons of the fund are present; and (g) the independent directors must be authorised to hire employees and to retain advisers and experts necessary to carry out their duties. The requirements noted in items (a) and (d) above were subsequently vacated by U.S. federal court decisions, and to date, the SEC has not re-proposed them. Registered funds that rely on the 1940 Act exemptive rules therefore must comply with the fund governance standards set out in Rule 0-1(a)(7), other than items (a) and (d) above, and have independent directors that constitute at least a majority of the fund's board, which was the requirement in effect before Rule 0-1(a)(7) was adopted. See Role of Independent Directors of Investment Companies, SEC Release No. IC-24816 (Jan. 2, 2001).

The 1940 Act requires the board of directors of a registered fund to carry out specific responsibilities to monitor the activities of the fund and to monitor self-dealing by the sponsor or investment adviser to the fund. For example, the board of a registered fund is responsible for: (a) approving the fund's investment advisory agreement, underwriting agreement and distribution plans; (b) adopting a code of ethics governing the personal trading activity of the fund's personnel and access persons; (c) selecting independent auditors for the fund; (d) designating the Chief Compliance Officer of the fund, and his or her compensation; (e) adopting or approving the written policies and procedures of the fund, and its investment adviser, principal underwriter, administrator and transfer agent, based on a finding by the board that the policies and procedures are reasonably designed to prevent violations of U.S. securities laws; and (f) reviewing, at least annually, a written report of the fund's Chief Compliance Officer in order to determine the adequacy and effectiveness of the fund's compliance policies and procedures and those of its service providers.

The 1940 Act also imposes certain requirements regarding the voting rights of shareholders of a registered fund. Every share issued by a registered fund generally must have voting rights equal with every other voting share issued by the fund. Approval of a majority of the outstanding voting shares of a registered fund is required to approve, among other matters: (a) changes in the fund's investment objective (unless the prospectus specifically states that the investment objective can be changed without a shareholder vote); (b) changes in any fundamental investment policy of the fund; (c) the fund's investment advisory agreements and distribution plans; and (d) election and/or changes to the board of directors. Shareholder approval is also sometimes required to ratify the board's selection of independent auditors for the fund.

ii. Selection of investment adviser, and review and approval of investment advisory agreement

The investment advisory agreement between a registered fund and its investment adviser must be approved by a majority vote of the fund's shareholders, and is subject to procedural requirements regarding review and approval by the fund's board of directors. Under Section 15(a) of the 1940 Act, a registered fund's investment advisory agreement may continue in effect for more than two years only if it is approved at least annually by the fund's board of directors or a majority vote of the fund's shareholders. In addition, Section 15(c) of the 1940 Act requires that the investment advisory agreement, and renewals thereof, must be approved by a majority of directors who are not parties to the agreement or interested persons of any party to the agreement. Section 15(c) specifically imposes a duty on the fund's board of directors to request and evaluate such information as may be reasonably necessary to evaluate the terms of the investment advisory agreement, and obligates the investment adviser to provide such information to the board. According to guidance provided in U.S. federal court decisions and followed by the SEC, material factors that are reasonably necessary for the board to evaluate an investment advisory agreement include: the nature and quality of the adviser's services; the performance of the fund and the adviser; the adviser's cost in providing services to the fund; the profitability of the fund to the adviser; the extent to which the adviser realises economies of scale as the fund grows larger; fee structures for comparable funds; and any fall-out benefits accruing to the adviser or its affiliates. See, e.g., *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982); *Jones v. Harris Associates L.P.*, 559 U.S. 335 (2010). Recordkeeping rules under the 1940 Act require registered funds to retain copies of materials that the board reviewed in connection with approving the funds' investment advisory agreements. According to the SEC, maintenance of such records by a fund facilitates an SEC examiners' review of whether the fund's board of directors has obtained the necessary information to be able to conduct informed evaluations of the fund's investment advisory agreement. See Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, SEC Release No. IC-26486 (Jun. 23, 2004).

iii. Capital structure

Section 18 of the 1940 Act imposes strict requirements on a registered fund's capital structure. The requirements are designed to ensure that all shareholders of the fund are treated equitably and that shareholders are not subject to the increased risks of a highly-leveraged investment strategy. For example, open-end funds are permitted to issue only one class of equity securities, and borrowing by open-end funds is only permitted under certain circumstances, including maintenance of asset coverage of at least 300% for all borrowings. Closed-end funds are permitted to issue only three classes of securities: one class of common; one class of preferred; and, generally, one class of debt. In addition, closed-end funds are required to maintain certain asset coverage ratios with respect to their senior securities: (a) preferred stock (together with any borrowings and debt securities) may not represent more than 50% of a closed-end fund's assets less liabilities other than borrowings and debt securities; and (b) borrowings and debt securities may not represent more than 33% of a closed-end fund's assets less liabilities other than borrowings and debt securities. If a closed-end fund fails

to maintain the required asset coverage on its senior securities, the fund may be prohibited from paying dividends on or repurchasing any junior security and, if continued long enough, holders of senior securities issued in compliance with the 1940 Act may be entitled to elect a majority of the fund's directors.

Some registered funds may pursue alternative investment strategies through the use of derivative instruments. However, certain derivative instruments sold by, and certain derivative transactions entered into by, a registered fund, may be considered an impermissible separate class of equity or debt securities unless the fund segregates assets or "covers" the transaction through an offsetting transaction. On November 25, 2019, the SEC proposed new Rule 18f-4 which, if adopted, would supersede the SEC's previously issued guidance regarding the use of derivatives by registered funds. The SEC's proposal was substantially revised from the original version of the rule that was proposed by the SEC on December 11, 2015. As proposed, Rule 18f-4 would impose new compliance obligations on registered funds that enter into derivative transactions, including fund leverage risk limits for derivatives transactions based on daily testing of a registered fund's relative value at risk ("**VaR**").

iv. Limits on portfolio investments

The 1940 Act restricts the investments that can be made by registered funds. For example, a registered fund is limited in its ability to purchase securities of, or sell its securities to, other registered and unregistered funds. The 1940 Act also restricts investments by registered funds in securities-related issuers, such as brokers/dealers, underwriters, investment advisers (or companies that derive more than 15% of their revenues from securities-related businesses) and insurance companies. Most derivative counterparties are investment banks that are generally considered securities-related issuers, and therefore, registered funds may be limited in their ability to enter into certain derivative contracts which involve economic exposure to such investment banks. The 1940 Act also limits the ability of a registered fund to acquire voting securities of an issuer if, to the knowledge of the fund, cross-ownership or circular ownership exists between the fund and the issuer. A registered fund may not concentrate more than 25% of its investments (including debt securities) in a particular industry unless the fund specifies in its registration statement such industry or group of industries in which it is concentrated.

Registered open-end funds, such as mutual funds, are also subject to restrictions regarding illiquid investments, and to the liquidity risk management requirements of Rule 22e-4, which was adopted by the SEC on October 13, 2016. Under Rule 22e-4, registered open-end funds are generally required to adopt and implement a written liquidity risk management programme and adhere to certain investment restrictions, such as: prohibiting a fund's acquisition of any illiquid investment if, immediately after such acquisition, the fund would have invested more than 15% of its net assets in illiquid investments; and establishing a minimum percentage of the fund's net assets required to be invested in highly liquid investments.

v. Conflicts of interest

The 1940 Act imposes strict limits on a registered fund's transactions with affiliates and affiliates of affiliates, which are designed to regulate situations where there is a risk that the fund may be overreached by such affiliated persons. For example, under Section 17 of the 1940 Act, a registered fund's affiliates, promoters, principal underwriters, and their affiliates, are prohibited from engaging in principal transactions to purchase property from or sell property to the fund, or borrow money from the fund. For these purposes, "affiliate" of a fund, as defined in Section 2(a)(3) of the 1940 Act, includes any person or entity which: (a) holds 5% or more of the outstanding voting securities of the fund; (b) has outstanding voting securities, 5% or more of which are owned by the fund; (c) controls, is controlled by or is under the common control with the fund; (d) is an officer, director, partner or employee of the fund; or (e) is the fund's investment adviser or member of an advisory board thereof. Section 17 of the 1940 Act also limits the compensation that affiliates (and affiliates of such affiliates) of a registered fund may accept for acting as an agent in connection with the purchase or sale of property from or to such fund. A registered fund's affiliates and principal underwriters, and their affiliates, are also prohibited from engaging in "joint transactions" (interpreted very broadly by the SEC) with such fund. In addition, Section 10 of the 1940 Act restricts purchases of securities by a registered fund during an underwriting syndicate if any affiliate of such fund is a principal underwriter for the issuer. Rules under the 1940 Act exempt certain affiliated and other prohibited transactions, provided certain conditions are met, and upon an application request, other such transactions may be exempted by SEC order.

vi. Reporting and recordkeeping

Registered funds must be sent to their shareholders' audited annual reports and unaudited semi-annual reports within 60 days after the end of the fiscal year and second quarter, respectively. Such reports must contain financial statements and certain additional information, such as a list of amounts and values of securities owned on the date of the balance sheet, a statement of the aggregate remuneration paid to the directors by the fund during the period covered by the report, and a statement of the aggregate dollar amounts of purchases and sales of investment securities made during such period. These shareholders reports must be filed with the SEC on Form N-CSR, accompanied by certifications of the fund's principal executive and principal financial officers, and are made publicly available. Additional disclosure must be made on Form N-CSR filings, such as a description of matters submitted to a vote of the fund's shareholders during the period covered by the report.

Registered funds are also required to file with the SEC all shareholder meeting proxy materials sent to shareholders in accordance with proxy rules under the U.S. Securities Exchange Act of 1934 (the "**Exchange Act**"), file annual reports on Form N-PX disclosing how the fund voted proxies on portfolio holdings, and file additional annual reports on Form N-CEN. Currently, registered funds are also required to file a list of their investment holdings on Form N-Q, but such reports have been rescinded effective May 1, 2020 pursuant to amended rules adopted by the SEC on October 13, 2016. Under the amended rules, the SEC adopted a new quarterly filing requirement on Form N-PORT, which requires monthly data on a fund's portfolio holdings, such as pricing of portfolio securities, information regarding repurchase agreements, securities lending activities and counterparty exposures, terms of derivative contracts and discrete portfolio-level and position-level risk measures. According to the SEC, information reported on Form N-CEN and Form N-PORT will help the SEC understand trends in the fund industry, carry out regulatory responsibilities, and analyse and understand the various risks in a particular fund, as well as across the industry as a whole.

Registered funds are required to maintain specified records, including sales literature, advertisements and pamphlets, director-questionnaires, materials reviewed in connection with approving the advisory contract, certain transaction reports, research and advisory materials for at least six years (with such records being maintained for at least two years on site). Registered funds are also required to permanently maintain

(with such records being maintained for at least two years on site) certain financial, transactional and shareholder records, and corporate charters, by-laws and minutes. The SEC is authorised to conduct examinations of such records.

vii. Other

Registered funds are subject to additional requirements under the 1940 Act, such as those relating to maintenance of fidelity insurance bonds, custody of fund assets, and share price determinations for sales, repurchases and redemptions of open-end fund shares, as well as requirements under other U.S. regulatory frameworks, including anti-money laundering regulations, customer privacy laws, and U.S. tax laws (as further discussed in section 4 below).

2.2 Are investment advisers that advise public funds required to be registered and/or regulated in your jurisdiction? If so, what does the registration process involve?

An investment adviser to a fund that is registered under the 1940 Act generally must be registered as an investment adviser under the U.S. Investment Advisers Act of 1940 (the "**Advisers Act**"), and comply with all the requirements thereunder. Investment advisers register on Form ADV, which includes a submission to jurisdiction and service of process in the U.S., and an undertaking to make records available to the SEC. The Form ADV requires detailed disclosures regarding, among other things, the adviser's business practices, investment methods, ownership structure, disciplinary history, types of compensation and affiliations with financial industry participants. Part 1 and Part 2A of Form ADV are filed electronically through the Investment Adviser Registration Depository ("**IARD**"), and after filing, such documents are publicly accessible on the SEC's Investment Adviser Public Disclosure website. Part 2B of Form ADV may need to be completed with respect to certain supervised persons of the investment adviser and delivered to clients, but is not required to be filed with the SEC or made publicly available. The SEC must approve an adviser's application for registration within 45 days after the date of the filing or institute proceedings to determine whether registration should be denied.

2.3 In addition to the requirements above, are there additional regulatory restrictions and requirements imposed on investment advisers that advise public funds?

As registered advisers under the Advisers Act, investment advisers to registered funds are subject to numerous compliance obligations, including: adopting a Code of Ethics to address compliance with applicable U.S. securities laws and to monitor personal trading activity of certain employees; implementing a written compliance programme and appointing a chief compliance officer to administer such programme; providing adequate supervision of personnel who are subject to the adviser's control; establishing written policies and procedures reasonably designed to prevent the misuse of material, non-public information, including insider trading, front-running (trading ahead of client orders) and scalping (trading ahead of client recommendations); and complying with Advisers Act requirements and SEC guidance such as those regarding advertising and use of performance data, best execution, custody of client assets, principal and agency cross transactions, brokerage arrangements, aggregation and allocation practices, trade error correction, proxy voting procedures and recordkeeping.

If a registered fund invests or trades in "commodity interests", the fund's operator and investment adviser may be required to register as a commodity pool operator ("**CPO**") or commodity trading adviser ("**CTA**") under the U.S. Commodity Exchange Act ("**Commodity Exchange Act**") and the rules of the U.S. Commodity Futures Trading Commission ("**CFTC**"). The Commodity Exchange Act and CFTC Rules regulate sales and trading in "commodity interests", including swaps, futures contracts, options on futures contracts and commodity options. Registered CPOs and CTAs are subject to regulation under the Commodity Exchange Act and the CFTC Rules, and are required to become members of the National Futures Association ("**NFA**"), subject to NFA member rules.

2.4 Are there any requirements or restrictions in your jurisdiction for public funds investing in digital currencies?

As of the time of writing, no public exchange-traded funds investing in digital currencies have been approved in the U.S. The SEC and its staff primarily cited concerns around the cryptocurrency spot market, including the online exchanges where such assets trade. For more information, please see Davis Polk & Wardwell LLP's chapter entitled "The Current State of U.S. Public Cryptocurrency Funds" within this guide.

2.5 Are there additional requirements in your jurisdiction for exchange-traded funds?

Exchange-Traded Funds ("**ETFs**") must either meet the requirements of new Rule 6c-11 under the 1940 Act or apply to the SEC for exemptive relief from various requirements of the 1940 Act that would otherwise inhibit their operation as ETFs. In addition to meeting 1940 Act requirements, an ETF would also be required to comply with the listing standards of the exchange upon which it lists its shares. To the extent an ETF does not fall within existing exchange listing standards, an additional SEC exemptive order may also be necessary.

On September 26, 2019, the SEC adopted Rule 6c-11 to modernise the regulation of ETFs by establishing a clear and consistent framework for the majority of ETFs. The new rule and related form amendments became effective on December 23, 2019, with a one-year transition period for compliance with the form amendments. Rule 6c-11 provides ETFs within its scope with exemptions from certain provisions of the 1940 Act, allowing such ETFs to: (i) redeem shares only in creation unit aggregations; (ii) permit ETF shares to be purchased and sold at market prices rather than at net asset value per share ("**NAV**"); (iii) engage in in-kind transactions with certain affiliates; and (iv) in limited circumstances, pay authorised participants redemption proceeds more than seven days after shares are tendered for redemption.

Rule 6c-11 is currently available only to transparent ETFs organised as open-end funds that are index-based or actively managed, which constitute the vast majority of today's ETFs. ETFs that are: (i) organised as unit investment trusts; (ii) structured as a share class of a multi-class fund; or (iii) leveraged/inverse ETFs (i.e., ETFs that seek directly or indirectly to provide returns at a multiple of a specific index over a fixed period of time, or, which seek to provide returns that have an inverse relationship to the performance of a specific index over a fixed period of time) cannot rely on Rule 6c-11 in its current form. However, on November 25, 2019, the SEC proposed to amend Rule 6c-11 to permit leveraged/inverse ETFs to rely on the rule (along with new Rule 18f-4 under the 1940 Act, which,

if enacted, would impose requirements on the use of derivatives and certain other transactions by certain registered funds).

Rule 6c-11 imposes conditions on ETFs relying on the rule, including, among other things, requirements that such ETFs: (i) be listed on a national securities exchange; (ii) provide daily portfolio transparency on their website; (iii) for ETFs that use "custom baskets" (i.e., baskets that do not reflect a *pro rata* representation of the fund's portfolio or that differ from the initial basket used in transactions on the same business day), adopt written policies and procedures that set forth the parameters for constructing and accepting such custom baskets; and (iv) disclose certain information on their website.

For example, an ETF relying on the rule must disclose prominently on its publicly available website the portfolio holdings that will form the basis for each calculation of NAV per share, and any cash balancing amount (if any), each business day before the opening of regular trading on the primary listing exchange of the ETF's shares. The ETF must disclose for each portfolio holding on a daily basis, the: (1) ticker symbol; (2) CUSIP or other identifier; (3) description of holding; (4) quantity of each security or other asset held; and (5) percentage weight of the holding in the portfolio.

The ETF must also provide website disclosure of: (i) the ETF's NAV per share, market price and premium or discount, each as of the end of the prior business day; (ii) historical information regarding the median bid-ask spreads over the most recent 30 days; and (iii) historical information, in a table and line graph, illustrating the extent and frequency of the ETF's premiums and discounts for the most recently completed calendar year and the most recently completed calendar quarters of the current year. If an ETF's premium or discount is greater than 2% for more than seven consecutive trading days, the ETF is also required to post such information on its website, and disclose the factors that are reasonably believed to have materially contributed to the premium or discount.

In addition, the ETF must comply with certain recordkeeping requirements, including preserving and maintaining copies of all written authorised participant agreements. For each basket exchanged with an authorised participant, an ETF must maintain a record including: (i) the ticker symbol, CUSIP or other identifier, description of holding, quantity of each holding and percentage weight of each holding within the basket; (ii) identification of the basket as a custom basket and stating that the custom basket complies with the ETF's custom basket policies and procedures (if applicable); (iii) the cash balancing amount (if any); and (iv) the identity of the authorised participant. An ETF will be required to maintain such records for at least five years, and do so in an easily accessible place for the first two years.

In addition to the above requirements of Rule 6c-11, ETFs must also comply with specific requirements contained in the registration statement used for such ETF (Form N-1A for open-end ETFs or Form N-8B-2 for unit investment trust ETFs), as well as certain reporting requirements specific to ETFs contained in documents required to be filed with the SEC (such as Form N-CEN). The foregoing discussion is focused on ETFs that invest primarily in securities. Additional or different requirements would apply to other types of ETFs, such as those primarily investing in commodities or commodity derivatives.

3 Marketing of Public Funds

3.1 What regulatory frameworks apply to the marketing of public funds?

The marketing of securities in the U.S., including shares of funds registered under the 1940 Act, is subject to the Exchange Act, the U.S. Securities Act of 1933 (the "**Securities Act**") and the SEC rules thereunder. Persons subject to licensure, as described in question 3.2, are generally also subject to the Exchange Act, the SEC rules thereunder, and the rules of the Financial Industry Regulatory Authority ("**FINRA**"). The marketing of registered funds is also subject to 1940 Act requirements regarding advertising and distribution plans, and advertising restrictions under Advisers Act provisions applicable to the funds' investment advisers.

3.2 Is licensure with a regulatory authority required of persons (whether entities or natural persons) engaged in marketing activities? If so: (i) are there commonly available exceptions that may be relied on?; and (ii) describe the level of substantive regulation applied to licensed persons.

The Exchange Act provides that a person "engaged in the business of effecting transactions in securities for the account of others" is a generally a "broker" and, absent an exception, must register with the SEC if the person "induces or attempts to induce the purchase or sale" of securities. As a result, a person (whether a legal entity or natural person) that solicits U.S. investors to purchase registered fund securities may be subject to registration with the SEC as a broker-dealer. Therefore, registered funds in the U.S. are typically sold through registered broker-dealers. Natural persons may avoid individual registration by becoming associated with an entity that is a registered broker-dealer.

Natural persons associated with a registered fund's investment adviser may seek to rely on a safe harbour from being deemed a "broker" subject to registration or association with a registered broker-dealer. Under Rule 3a4-1 under the Exchange Act, a partner, officer, director or employee of an investment adviser to a registered fund would not be deemed to be a "broker" in connection with the person's participation in the sale of the registered fund's securities, where a number of particular conditions are met, including that the person is not compensated through commissions or similar remuneration that is dependent on whether transactions in securities occur, that the person has substantial duties for the adviser unrelated to selling securities, and that the person limits their participation in particular ways.

Registered broker-dealers and their natural person associated persons are subject to extensive substantive regulation. In addition to registration with the SEC, broker-dealers are also generally required to become members of FINRA and register with applicable states. Broker-dealers are subject to minimum regulatory capital requirements, limitations on distribution of assets to affiliates, regulation of their handling of customers' fund and securities, regulation of their sales practices, limitations on margin lending, significant ongoing regulatory events and financial reporting, annual financial audits, record creation and maintenance obligations, maintaining internal supervision and surveillance, anti-money laundering and know-your-customer requirements, restrictions on the content of communications with the public and obligations in connection with the preparation and potential filing requirements relating to these communications, requirements to obtain FINRA approval for material changes in business or certain changes in ownership, generally adhering to high standards of commercial honour and just and equitable principles of trade, among other obligations. A natural person seeking to become associated with a broker-dealer must pass qualifying examinations administered by FINRA, subject themselves to fingerprinting and provide disclosure of extensive background information. Registered individuals may be subject to restrictions on the business activities that they engage in outside

the scope of their association with the broker-dealer, including personal securities transactions, must meet continuing education requirements, and are subject to various ongoing reporting requirements. Broker-dealers and their natural person associated persons are subject to examination and enforcement by the SEC, applicable states, FINRA and any other self-regulatory organisation of which the broker-dealer is a member.

3.3 What are the main regulatory restrictions and requirements in the following areas, if any, that must be complied with by entities that are involved in marketing public funds?

i. Distribution fees or other charges

FINRA Rule 2341 prohibits FINRA member broker-dealers from engaging in the sale of registered fund securities if the sales charges are "excessive", as defined in the rule. The rule sets forth particular maximum sales charges that differ depending on the relevant fee structures and mix of fees, with the aggregate maximum sales charges generally ranging from 6.25% to 8.5%. FINRA also requires that, to the extent that volume breakpoints or other fee discounts are promised, FINRA members ensure that customers receive them.

ii. Advertising

FINRA Rule 2210 requires that all broker-dealer communications, including advertisements for registered funds, be based on principles of fair dealing and good faith, be fair and balanced, and provide a sound basis for evaluating the facts, while not omitting any material fact that would cause the communications to be misleading. Broker-dealers also may not include any false, exaggerated, unwarranted, promissory or misleading statement or claim in any communication, and must ensure that statements are clear and not misleading within the context in which they are made, and that they provide balanced treatment of risks and potential benefits. Communications may not predict or project performance, or imply that past performance will recur. FINRA generally interprets these requirements as prohibiting communications from containing performance information that is not the actual performance of the particular fund – such as hypothetical or back-tested performance, information on targeted returns, or information regarding the performance of a related investment.

Advertisements that are expected to be distributed or made available to more than 25 retail investors within a 30-day period generally must be internally pre-approved by particular licensed personnel. When such advertisements relate to registered funds, they must be filed with FINRA within 10 days of first use. Additional obligations apply to the use of advertisements for registered funds that contain certain performance rankings or comparisons, including a requirement to file those materials with FINRA 10 days prior to first use.

Advertisements and sales literature regarding registered funds must also generally comply with specific form and content requirements under SEC rules, such as Rule 34b-1 under the 1940 Act, and Rule 482 under the Securities Act. Such marketing materials are also subject to anti-fraud provisions of the U.S. federal securities laws, including Rule 206(4)-1 under the Advisers Act, which prohibit misleading or deceptive advertising practices.

iii. Investor suitability and best interest

Under FINRA Rule 2111, a broker-dealer recommending a security transaction, including the purchase of registered funds, must have a reasonable basis to believe that the transaction is suitable for the customer, based on the customer's investment profile (including the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose). Suitability analysis requires consideration of: (i) reasonable-basis suitability (that the registered fund is suitable for at least some investors); (ii) customer-specific suitability (that the recommended transaction is suitable for the particular customer); and (iii) quantitative suitability (that even if suitable in isolation, the recommended transaction is suitable and not excessive in light of other recommended transactions). With respect to certain institutional investors, a broker-dealer may satisfy its customer-specific suitability obligation under FINRA Rule 2111 if it has a reasonable basis to believe that the institutional customer is capable of evaluating investment risks independently and the institutional customer has affirmatively indicated that it is exercising independent judgment in evaluating the broker-dealer's recommendations.

Effective June 30, 2020, a new SEC rule, Regulation Best Interest ("**Reg BI**") will go into effect and impose additional requirements on broker-dealers recommending investments, including registered funds, to retail investors. In general, Reg BI will require that broker-dealers: (i) only make recommendations to retail customers that are in those customers' "best interest", without placing the financial or other interest of the broker-dealer ahead of the interests of the retail customer; and (ii) identify, disclose or in some cases eliminate, conflicts of interest relating to their recommendations.

iv. Custody of investor funds or securities

Most broker-dealers that act as the marketing agent for registered funds do not themselves have the regulatory permission or capacity to maintain custody of customer funds or securities, but instead: (i) market the funds, with actual sales effected through customer's own separate broker-dealers; (ii) arrange for transactions on a "subscription-way" basis, whereby the customer provides funds directly to the registered fund or its transfer agent, who maintains records of the customer's ownership; or (iii) introduce the customer transaction to a "clearing" broker-dealer that has the required regulatory permission and infrastructure to handle customer assets.

Clearing brokers are subject to particular requirements in connection with their maintenance of custody of customer funds and securities, including registered fund shares. With respect to securities, the broker must maintain physical possession or "control" of all fully-paid securities, and those securities pledged for margin loans exceeding specified thresholds. This means that the broker-dealer generally must keep these securities either on its own premises or at a U.S. bank, another U.S. broker-dealer or a central securities depository regulated by the SEC. The broker-dealer may not sell or pledge those securities or otherwise use them to support its own business. To the extent that the registered fund shares are not fully-paid, or otherwise have been pledged to the broker-dealer as collateral below the applicable margin threshold, the broker-dealer is permitted to pledge and otherwise rehypothecate those securities, subject to certain limitations.

With respect to cash, clearing brokers are required to conduct a periodic calculation that approximates the net amount of cash that it owes to customers (i.e., cash customers have deposited with the broker, less cash the broker has lent to customers, subject to a number of adjustments), and deposit that amount in a special reserve bank account held at an unaffiliated bank for the exclusive benefit of its customers. As a result, cash deposited with a clearing broker is effectively segregated into a separate omnibus bank account held for the broker's customers.

3.4 Are there restrictions on to whom public funds may be marketed or sold?

The 1940 Act imposes restrictions on the sale of securities issued by registered funds to other registered and unregistered funds. Otherwise, there are no investor eligibility restrictions on funds that are registered under the 1940 Act, assuming the fund recommended is suitable or in the best interest of the investor, if applicable.

3.5 Are there other main areas of regulation that are imposed with respect to the marketing of public funds?

Registered funds are subject to 1940 Act restrictions on compensation arrangements relating to distribution of the funds' securities. For example, under Rule 12b-1(h) under the 1940 Act, a registered fund may not compensate a broker or dealer for any promotion or sale of its shares by directing portfolio securities transactions to such broker or dealer.

4 Tax Treatment

4.1 What are the types of entities that can be public funds in your jurisdiction?

Various types of entities can be registered funds, including entities treated as partnerships, grantor trusts or corporations for U.S. federal income tax purposes. The choice of entity depends on the fund's investment strategy, as well as other factors. If a registered fund will invest in stocks and securities (as opposed to commodities), it is quite common for the fund to elect to be treated as a regulated investment company (a "**RIC**") for U.S. federal income tax purposes. This section 4 will focus on the U.S. federal income tax treatment of, and qualification requirements for, a RIC.

4.2 What is the tax treatment of each such entity (both entity-level tax and taxation of investors in respect of allocations of income or distributions, as the case may be)?

Assuming that a fund elects to be treated as a RIC and satisfies the relevant requirements for that status, the fund generally will not be subject to U.S. federal income tax on income that it distributes to its shareholders, provided that, for each taxable year, it distributes on a timely basis at least 90% of the sum of: (i) its "investment company taxable income" (generally, its taxable income other than net capital gain, with certain modifications); and (ii) its net tax-exempt interest income. Net capital gain is the excess, if any, of net long-term capital gains over net short-term capital losses. Gain or loss from the fund's disposition of an investment will be treated as long term if the fund's holding period for the investment is more than one year on the date of disposition. In addition, an RIC will be subject to a 4% excise tax on certain undistributed income if it does not distribute during each calendar year (which may be different from its taxable year) at least: (i) 98% of its ordinary taxable income for the year; (ii) 98.2% of its net capital gains for the one-year period ending on October 31; and (iii) any income or gains not distributed in prior years.

Except as described below, distributions out of a RIC's current or accumulated earnings and profits will be treated as ordinary income, which is subject to U.S. federal income tax in the hands of the investors at the highest marginal rates. The portion of any such distribution that the RIC designates as made out of net capital gains or (if the investor meets an applicable holding period requirement with respect to his or her shares in the RIC) "qualified dividend income" will retain that character and will therefore be subject to lower tax rates in the hands of non-corporate investors. If at least 50% of the value of a RIC's assets consists of tax-exempt state and local bonds, the RIC can designate the portion of a distribution that is made out of tax-exempt interest as such, and that portion will be tax-exempt. If a RIC retains net capital gains, it may elect to treat those gains as distributed to the investors, in which case the investors will be entitled to tax credits equal to their shares of the tax paid by the RIC on the retained gains. A distribution in excess of the RIC's current and accumulated earnings and profits will be treated as a tax-free return of capital to the extent of the tax basis of the investor's shares and thereafter as capital gain from a sale of those shares.

Except as described below, a distribution by a RIC to a non-U.S. investor out of the RIC's current or accumulated earnings and profits will be subject to withholding tax at a 30% rate or such lower rate as may be specified by an applicable income tax treaty. Provided that certain requirements are satisfied, this withholding tax will not be imposed on the portion of any such distribution that is made out of the RIC's net capital gain, short-term capital gain (that is, the excess of net short-term capital gains over net long-term capital losses) or U.S.-source interest income. In certain circumstances, a distribution by a RIC of gains derived from U.S. real-estate-related investments could subject a non-U.S. investor to regular U.S. federal income tax and a U.S. tax return filing requirement.

4.3 If a public fund, or a type of entity that may be a public fund, qualifies for a special tax regime, what are the requirements necessary to permit the entity to qualify for this special tax regime?

In order to qualify as a RIC, a fund must: (i) be organised as a U.S. entity that is treated as a corporation for U.S. federal income tax purposes; (ii) be registered under the 1940 Act or meet certain other regulatory requirements; (iii) elect to be treated as a RIC; and (iv) meet an annual "qualifying income" test and a quarterly asset diversification test. A fund will meet the "qualifying income" test for any taxable year if at least 90% of its gross income for the year consists of certain types of investment income derived from investments in stocks, securities or foreign currencies (including options, futures or forward contracts with respect to such assets). Investments in cryptocurrencies that are not treated as securities for purposes of the 1940 Act do not produce "qualifying income" and, as a result, a fund that invests primarily in such cryptocurrencies would not qualify as a RIC (as defined in this section 4). In order to meet the asset diversification test, a fund must generally diversify its holdings so that, at the end of each quarter: (i) at least 50% of the value of its assets consists of cash, U.S. government securities, securities of other RICs and other securities, with such other securities limited, in respect of any issuer, to an amount not greater than 5% of the value of the fund's assets and not greater than 10% of the issuer's voting securities; and (ii) not more than 25% of the value of its assets consists of (x) the securities (other than U.S. government securities and securities of other RICs) of any one issuer, or of two or more issuers that the fund controls and that are engaged in the same, similar or related businesses, or (y) in the securities of one or more publicly traded partnerships (other than such a partnership that would itself satisfy the RIC "qualifying income" test).

If a fund that has elected RIC status fails to satisfy the income or diversification test for any taxable year, it may be able to avoid losing its status as an RIC by timely curing such failure, paying a tax and/or providing notice of such failure to the U.S. Internal Revenue Service. If the fund does lose its status as an RIC, it could be required to recognise unrealised gains, pay taxes and make distributions (which could be subject to interest charges) before requalifying.

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