UNITED STATES

Investment rules of the world

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At DLA Piper, we have one of the largest finance and projects teams in the world with more than 600 dedicated lawyers and an established local law firm network. We share knowledge and skills in debt instruments, debt securities, funds, derivatives and portfolios, as well as energy, infrastructure and other projects, across Europe, the Middle East, Africa, Asia Pacific and the Americas.

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With global perspective, we can help you to realize your financial strategy in whichever markets you do business.

Investment Rules of the World

With input from across our global network, this guide covers key legal topics for different financial activities and projects and gives you an overview of the points you may consider when initially looking at financing or investing in particular jurisdictions. Please contact us if you would like to discuss any legal issues or solutions for your business. We also welcome your feedback about this guide via investmentrules@dlapiper.com.

United States

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Capital markets and structured investments

Issuing and investing in debt securities

Are there any restrictions on issuing debt securities?

The offering and sale of debt securities is subject to both federal and state securities laws.

For an issuance of debt securities to be permitted under federal law, the issuance must either be registered under the Securities Act of 1933 (Securities Act), or the issuance must be exempt from registration pursuant to an exemption from the registration requirements of the Securities Act.

For certain debt securities, the Trust Indenture Act of 1939 (TIA) will also apply. However, the TIA does not apply to private placements. As a result, only debt securities issued in a registered offering, or subsequently registered in an 'A/B exchange offer' will be subject to the TIA. However, indentures for debt securities issued in the high yield market may incorporate by reference all, or a portion, of the TIA, although this is fading as a market practice.

State securities laws (known as 'blue sky' laws) regulate both the offering and sale of debt securities as well. However, federal law pre-empts state securities laws for certain types of offerings, particularly registered offerings.

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What are common issuing methods and types of debt securities?

Debt securities may be offered either in a registered offering or an unregistered offering which is exempt from registration.

Registered offerings of debt securities are most common in the investment grade context, where many issuers are 'well-known seasoned issuers' (WKSIs) and can therefore rely on the filing of an automatically effective registration statement on Form S-3 for the offering. For issuers which are not WKSIs, a registration statement would have to be filed, reviewed by the Securities and Exchange Commission, and only after the review was completed and the registration statement declared effective could the offering commence.

To avoid the delay of the registered offering process, many issuers rely on exemptions from the Securities Act of 1933 (Securities Act) to complete debt securities offerings. Two of the principal exemptions utilized in the debt securities market are Section 4(a)(2) of the Securities Act and Rule 144A issued under the Securities Act.

Section 4(a)(2) exempts from the registration requirements of the Securities Act 'transactions by an issuer not involving any public offering.' A broad range of private placements may be structured to rely on the exemption under Section 4(a)(2), including offerings arranged by the issuer directly and offerings where an investment bank acts as a placement agent. Among these are private placements which rely on the safe harbor provided by Regulation D.

Rule 144A provides a resale exemption, which is commonly relied upon in connection with debt securities offerings where an investment bank acts as an initial purchaser (similar to an underwriter) of the debt securities, then resells the debt securities to the ultimate purchasers. Rule 144A is not an exemption which is available to the issuer for the initial sale to the investment banks (that issuance is usually a Section 4(a)(2) private placement). Securities issued initially in a Rule 144A offering may be subsequently registered under the Securities Act through an 'A/B exchange offer.'

Numerous types of debt securities are offered in US markets. Among the most common are:

- debt securities issued by a corporate issuer, including fixed-rate securities, floating-rate securities, variable-rate securities, zero-coupon securities, Payment-in-Kind (PIK) toggle bonds and high-yield bonds;
- asset-backed securities;
- government securities (federal government bonds and bills, state and local municipal bonds, and bonds issued by government-controlled entities);
- derivative securities such as securities linked to the value of one or more reference assets including shares, commodities, interest rate, currency rate or ndex and credit-linked notes; and
- equity-linked securities such as convertible bonds (debt securities convertible into the equity of the issuer).

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What are the differences between offering debt securities to institutional / professional or other investors?

The US debt securities market is dominated by institutional investors. Non-institutional investors typically participate in the debt securities market through institutional vehicles such as Exchange Traded Funds (ETFs) and mutual funds.

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When is it necessary to prepare a prospectus?

Any registered securities offering under the Securities Act of 1933 will require the preparation and filing of a prospectus.

Rule 144A only requires certain limited disclosures to be made to investors, however market practice typically requires substantially the same disclosure in a Rule 144A offering as in a registered securities offering.

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What are the main exchanges available?

Debt securities in the US are not typically exchange listed, however all of the major exchanges including the New York Stock Exchange and NASDAQ permit the listing of debt securities.

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Is there a private placement market?

Yes, there are multiple private placement markets and sub-markets in the US. Insurance companies invest in private placements on a series of model forms promulgated by the American College of Investment Counsel. On the other hand, the market for high-yield bonds does not have a single dominant documentation standard.

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Are there any other notable risks or issues around issuing or investing in debt securities?

Issuing debt securities

An issuer of debt securities will be subject to certain of the anti-fraud protections of the US federal and state securities laws. As a result, an issuer of debt securities may be subject to claims from purchasers based upon the accuracy of the disclosure provided at the time of issuance, which would not apply in a loan transaction.

Investing in debt securities

As a holder of debt securities, the investor is typically not in direct contractual privity with the issuer and must rely upon a trustee to act on behalf of all the holders. As a result, collective action problems can develop, as different investors may have divergent interests and incentives.

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Establishing and investing in debt / hedge funds

Are there any restrictions on establishing a fund?

A US investment vehicle that is deemed an 'investment company' under US law and cannot rely on an exception or exemption from registration will generally be required to:

- register with the US Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 (ICA); and
- register its public offerings under the Securities Act of 1933 (Securities Act).

If registration is required, the investment company will be subject to various requirements and restrictions, including significant limitations on the ability of the investment company to make carried interest/performance fee payments to its investment manager.

Private investment funds, including hedge funds and debt funds, generally rely on the exceptions to the registration requirement set forth in Sections 3(c)(1) and 3(c)(7) of the ICA.

Section 3(c)(1)

Section 3(c)(1) of the ICA excepts any issuer whose outstanding securities (not including short-term paper) are beneficially owned by 100 persons or fewer and that is not making (and does not propose to make) a public offering of such securities. Where an entity holds more than 10% of the outstanding securities, the numerical cap on investors includes a 'look-through' to the ultimate owners of that entity. In practice, look-through determinations often require a complex law and fact analysis.

Pursuant to Securities Act requirements, an issuer availing itself of the section 3(c)(1) exception can raise an unlimited amount of capital, but all the investors must be sophisticated, and no more than 35 can be sophisticated without also being 'accredited investors.' If a general solicitation for investment is made, all investors must be 'accredited investors.'

Section 3(c)(7)

Section 3(c)(7) of the ICA excepts any issuer whose outstanding securities are owned exclusively by persons who, at the time of acquisition of such securities, are 'qualified purchasers' and that is not making (and does not propose to make) a public offering of such securities. Unlike the section 3(c)(1) exception, the Securities Act does not limit the number of investors, but private funds relying on the section 3(c)(7) exception generally cap investors at 1,999 (or less) in order to avoid registration requirements under the Securities Exchange Act of 1934.

A fund sponsor may be required to register as an Investment Adviser under the Investment Advisers Act of 1940.

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What are common fund structures?

Most private funds offered to investors who are subject to US tax are generally limited partnerships or limited liability companies (LLC). US entities are generally formed under the laws of a US state, rather than under national law. Most private funds are formed in Delaware.

In a master-feeder fund structure, the US feeder is generally a limited partnership or LLC formed in Delaware, while the offshore feeder and the master fund are formed or otherwise organized in a non-US jurisdiction. In most instances, a master fund will be taxed as a US partnership, which may require the filing of an election to that effect with the US Internal Revenue Service.

There are other fund structures common for registered investment companies which are not covered here.

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What are the differences between offering fund securities to professional / institutional or other investors?

Retail funds

Offerings made to the public must be registered with the Securities and Exchange Commission (SEC) under the Securities Act of 1933 (Securities Act) unless an exemption from registration is available. Importantly, if a fund publicly offers its securities, it loses the ability to rely on the Section 3(c)(1) or 3(c)(7) exemptions from registration under the Investment Company Act of 1940 (ICA). If a fund elects to make a public offering of its securities it must create disclosure materials that comply with the requirements of the Securities Act and obtain SEC review thereof, and observe the rules set forth in the Securities Act and the Securities Exchange Act of 1934 (SEA) relating to the conduct of such offerings. Such a fund generally would also be subject to the provisions of the ICA, including the prohibition on performance-based compensation.

Institutional/professional funds

Offerings made to professional or institutional investors are typically made via an exemption from registration under the Securities Act, Regulation D, that permits private offerings to 'accredited investors' with limited oversight by the SEC. 'Accredited investors' include:

- a person whose individual net worth (or joint net worth with that person’s spouse) exceeds USD1 million or who had an individual income in excess of USD200,000 in each of the two most recent years or joint income with that person’s spouse in excess of USD300, 000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; and
- an entity, not formed for the specific purpose of acquiring the securities offered, with total assets in excess of USD5 million.

Most funds offered to institutional investors are limited to 'qualified purchasers,' and, as discussed above, are offered in private placements. Qualified purchasers include:

- a person who owns at least USD5 million in investments; and
- a person or entity, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis at least USD25 million in investments.

So long as the conditions for the exemption from registration under the Securities Act are met the issuer is not required to obtain SEC review of the disclosure materials prior to the offering or to observe the rules relating to public offerings of securities. However, the fund remains subject to the Securities Act’s anti-fraud rules, and the fund must notify the SEC no later than 15 days after the first sale of a security in the private placement.

Fund issuers must also comply with state securities laws to the extent not superseded by applicable federal securities laws. In particular, there may be post-sale filing obligations in states where subscribers for private fund interests reside which should be considered.

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Are there any other notable risks or issues around establishing and investing in funds?

Establishing funds

A US fund deemed to be an 'investment company' must register with the Securities and Exchange Commission (SEC) under the Investment Company Act of 1940 (ICA) unless an exemption from registration is available. Failure to register when required may carry significant civil and criminal penalties for fund sponsors. In addition, an entity that provides investment advisory or management services to a fund may be required, depending on its aggregate assets under management (AUM), to register with the SEC as an Investment Adviser under the Investment Advisers Act of 1940 (IAA) or with its state securities regulator. The manager of a fund that is not required to register under the ICA may nevertheless be required to register under the IAA.

Prior to accepting investors, the fund must comply with applicable KYC and anti-money laundering rules as well as US tax rules (in particular the Foreign Account Tax Compliance Act), which may require obtaining identification information from potential investors.

In addition, the fund must confirm whether or not potential investors are subject to the Employee Retirement Income Security Act (ERISA), as the presence of such investors in the fund may cause the entire fund to be subject to ERISA's fiduciary duty rules and other restrictions. The fund and/or its management may also be required to register with the US Commodity Futures Trading Commission under the Commodity Exchange Act or apply for an exemption from registration.

Investing in funds

Potential investors in funds should note the following provisions of the fund's governing documents in the first instance:

- when and under what circumstances investors may be required to indemnify the fund's management or personnel for losses they incur related to the fund, or to return distributions previously made by the fund;
- what rights investors have to remove the fund's management;
- in closed-end funds, the priority of payments for distributable funds (the 'waterfall'), and the portion of such payments to be made as carried interest to the fund sponsor;
- in open-end funds, the methodology of computing performance compensation for the fund sponsor;
- the amount and timing of management fees payable to the fund sponsor;
- in open-end funds, when the investor may redeem/exit the fund;
- the circumstances in which an investor may transfer its interest; and
- the form and jurisdiction of the fund for tax purposes.

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Managing and marketing debt / hedge funds

Are there any restrictions on marketing a fund?

Funds that intend to market securities to the public in a registered transaction under the Securities Act of 1933 (Securities Act) must comply with the public offering rules set forth therein. Funds that intend to issue securities in private placements not subject to registration under the Securities Act must comply with the marketing restrictions in the relevant exemption. Under the most commonly-used exemption from registration under the Securities Act, Regulation D, sponsors marketing funds in a private placement may not engage in 'general solicitation' or 'general advertising' relating to the offering. This includes any advertisement, mass mailing, cold calls, article, notice, or other communication published in any newspaper, magazine, or similar media, or broadcast over television or radio, and also any seminar or meeting whose attendees have been invited by any general solicitation or advertising.

Under certain circumstances an issuer using Regulation D may engage in general solicitation or general advertising if the issuer takes additional steps to ensure that all securities sold in the offering are sold to accredited investors. Issuers choosing to market in this fashion must elect to do so and, once they have elected to do so, may not change their election.

Issuers in both registered and unregistered offerings of securities are liable for violations of the anti-fraud provisions of the Securities Exchange Act of 1934 relating to the contents of the disclosure materials provided in connection with the offering.

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Are there any restrictions on managing a fund?

A fund registered under the Investment Company Act of 1940 (ICA) must comply with the rules set forth therein, including restrictions on the manner and timing of payments to its manager. Funds using an exemption from registration under the ICA must comply with the terms of that exemption at all times.

If the fund's manager is registered with the Securities and Exchange Commission (SEC) it must meet the duties and obligations imposed by the Investment Advisers Act of 1940 (IAA). Managers exempt from registration must nevertheless obey anti-fraud and other rules in the IAA. All managers whether exempt from registration or not owe fiduciary duties to the fund as a matter of both federal and state law. For example, managers must ordinarily obtain the consent of the investors or a committee of them before causing the fund to enter into a transaction that is subject to a conflict of interest.

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Entering into derivatives contracts

Are there any restrictions on entering into derivatives contracts?

In the US the Commodity Futures Trading Commission (CFTC)and the Securities and Exchange Commission (SEC) share jurisdiction over the derivatives market depending on the underlying product that is being traded and whether the transaction is 'over-the-counter' (OTC) or traded on an exchange. In addition, banks and financial institutions are subject to the jurisdiction of the Prudential Regulators. Swap dealers and other entities that trade in large volumes need to be registered with the CFTC or the SEC depending on the underlying products being traded. In addition, US rules permit only 'eligible contract participants' (as defined under the Commodity Exchange Act) to enter into OTC derivatives.

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What are common types of derivatives?

All of the main types of derivative contract are widely used in the US:

- forwards;
- futures;
- swaps (such as interest rate or currency swaps); and
- options (call options and put options).

Products may be 'over-the-counter' (OTC) or exchange traded and entered into for hedging or as part of a trading strategy.

The transactions types that we see most often relate to interest rate or currency hedging such as FX forwards, interest swaps or interest rate caps. The needs of the relevant entity drive the underlying type of hedging. A power company client may have commodity hedging needs whereas a manufacturer may be concerned only with hedging the interest rate on its debt.

Common products that we see are commodity derivatives, equity derivatives, interest rate derivatives, currency derivatives, credit derivatives and insurance-linked derivatives.

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Are there any other notable risks or issues around entering into derivatives contracts?

Since the global financial crisis in 2007-to-2008, derivatives and particularly over-the-counter derivatives have attracted significant regulatory attention. As a result, the derivatives market has seen, and continues to see, the introduction of a significant amount of new regulation and this has led to substantial compliance costs for market participants.

There are business risks that need to be considered – although hedging is seen as a tool to minimize risk, an entity needs to consider whether the derivatives product is appropriate and assess the down-side risk. In most cases, a derivatives trading relationship requires the posting of margin; entities should consider whether they are in a position to post margin and, if so, the types of margin that are available as in some instances applicable rules limit the types of margin that may be posted. In addition, margin that is posted to a counterparty may be at risk and an entity may want to consider posting margin to a third-party custodian instead of directly to its counterparty.

Regulatory compliance

Rules promulgated by the Commodity Futures Trading Commission (CFTC) and Securities and Exchange Commission (SEC) pursuant to the Dodd-Frank Act may impose a compliance burden such as record keeping or trade reporting. In addition, European regulations or the regulations of another jurisdiction may be relevant depending on the location of the parties. As a result of new global regulations that affect the derivatives market, an entity may be required by its counterparty to sign up to certain industry protocols or provide information.

Operations

Derivatives trading often involves the exchange of margin and an entity must be operationally capable of posting, calling for and calculating margin. In addition, the entity needs to have processes and systems in place to manage trading activity and the related documentation.

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Debt finance

Lending and borrowing

Are there any restrictions on lending and borrowing?

Lending

The amount of regulation a lender faces will depend on the type of product (consumer or commercial) and the type of collateral securing the product (real estate or non-real estate). Consumer loans are more heavily regulated than commercial loans, with consumer loans secured by real estate being the most heavily regulated on both the federal and state level and unsecured commercial loans being the least regulated. That being said, it is unlikely for any credit product offered in the US to be completely unregulated in all states and jurisdictions.

Below are some general restrictions on lending.

PROHIBITION ON UNSAFE AND UNSOUND BANKING PRACTICES

The Federal Deposit Insurance Act (FDI Act) prohibits federally and state-chartered banks and thrift institutions from engaging in unsafe and unsound banking practices, including those relating to banks' lending activities. Regulators can impose corrective measures, including cease-and-desist orders or termination of the bank's deposit insurance coverage for a bank engaging in any unsafe or unsound banking practices.

CAPPING OF INTEREST RATES

State usury laws, which may apply to both federally and state-chartered banks, impose limitations on the interest rates that banks may charge for consumer and commercial loans.

LIMITS ON LOANS TO ONE BORROWER

Federal law caps the amount of credit that national banks are permitted to extend to one borrower or to a group of related borrowers, subject to specific exceptions which are tailored to the nature and type of loan. Some states have comparable limitations.

RESTRICTIONS ON LENDING TO AFFILIATES

Federal law restricts lending and other extensions of credit by a bank directly or indirectly to its affiliates by setting quantitative limitations on a bank's transactions with any single affiliate, and with all affiliates combined, and by setting forth collateral requirements for certain bank transactions with affiliates, among other restrictions and limitations.

RESTRICTIONS ON LENDING TO INSIDERS

Loan terms to insiders are closely regulated and some transactions can be prohibited entirely. Additional requirements for loans to executive officers and directors exist.

ANTI-TYING RULES

The Bank Holding Company Act (BHC Act) prohibits banks from requiring their customers to obtain any product or service, including non-bank products or services, as a condition to the extension of credit. Certain safe harbors exist.

PROHIBITIONS ON DISCRIMINATION

The Equal Credit Opportunity Act (ECOA) applies to all creditors and prohibits a lender from discriminating on the basis of a protected characteristic (race, color, religion, national origin, sex, marital status, age, the receipt of public assistance).

Below are some consumer-specific restrictions on lending.

CONSUMER LENDING DISCLOSURE OBLIGATIONS

Truth in Lending Act (TILA) and Regulation Z require certain disclosures to be made when providing consumer credit. The ECOA requires notification disclosures to be provided to denied applicants of consumer credit.

PROHIBITIONS ON UNFAIR, DECEPTIVE, OR ABUSIVE ACTS OR PRACTICES (UDAAPS) IN CONSUMER LENDING

The Dodd-Frank Act prohibits UDAAPs. For generic examples of what may be considered a UDAAP please consider the Consumer Financial Protection Bureau bulletin dated 10 July 2013.

ADDITIONAL PROHIBITIONS ON DISCRIMINATION

The Fair Housing Act prohibits discrimination on the basis of race, color, national origin, religion, sex, familial status, and handicap in all aspects of 'residential real estate related transactions, including but not limited to: (1) making loans to buy, build, repair, or improve a dwelling; (2) purchasing real estate loans; (3) selling, brokering or appraising residential real estate; or (4) selling or renting a dwelling.'

RESIDENTIAL MORTGAGE REQUIREMENTS

Residential mortgage origination, selling/purchasing, and servicing is closely regulated on both a federal and state level. Numerous restrictions, standards, and disclosure requirements specific to residential mortgages exist in this highly regulated space.

Borrowing

While borrowers are generally not regulated, it is advisable for borrowers to consider whether either the mortgage or consumer lending regimes apply to their activities, in which case they will benefit from the protections mentioned above.

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What are common lending structures?

Lending in the US can be structured in a number of different ways to include a variety of features depending on the commercial needs of the parties.

A loan can either be provided on a bilateral basis (a single lender providing the entire facility), a club basis (a small group of multiple lenders each providing parts of the overall facility) or syndicated basis (a larger group of multiple lenders each providing parts of the overall facility).

Loans can be secured or unsecured. Assets of a debtor can have multiple security interests attached thereto and such security interests are usually allocated among secured parties in respect of priority and other similar rights pursuant to an intercreditor agreement. A first-lien/second-lien loan can be combined into one unitranche loan. In this structure, the lenders enter into an agreement among lenders outside of the credit agreement with the borrower.

Club and syndicated facilities by their nature involve more parties (such as agents which fulfil certain roles for the finance parties), are more highly structured and involve more complex documentation. Larger financings will typically be done on a syndicated basis with one of the syndicate taking the lead in coordinating and arranging the financing.

Loans will be structured to achieve specific objectives, e.g. acquisition financing, dividend recapitalizations, working capital loans or letter of credit facilities.

Loan durations

The duration of a loan may include:

- a term loan, provided for an agreed period of time but with a short availability period;
- a revolving loan, provided for an agreed period of time with an availability period that extends nearer to maturity of the loan and which may be redrawn if repaid;
- a swingline loan, provided on a short-term basis to solve short-term cash flow issues; or
- a bridge loan, provided for up to a year and intended to bridge the gap until another financing source is available.

Loan security

A loan can either be secured, unsecured or guaranteed. For more information, see Giving and taking guarantees and security – common types.

Loan commitment

Lenders are obligated to provide the loan if certain conditions are fulfilled.

A credit agreement may also include an uncommitted incremental facility or an accordion, which allow the borrower to increase the commitments of the existing lenders or bring new lenders into the facility. The lenders do not commit upfront to providing additional loans.

Loan repayment

Typically, a term loan is repayable on an amortizing basis (in instalments over the life of the loan) or is repayable in full at maturity. Revolving loans may be reborrowed and repaid throughout the life of the facility.

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What are the differences between lending to institutional / professional or other borrowers?

Federal agencies, such as the US Consumer Financial Protection Bureau, regulate lending to consumers and in the context of residential real estate loans. Lenders in the context of commercial real estate loans should also consider zoning laws and environmental regulations.

For more information, see Lending and borrowing – restrictions.

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Do the laws recognize the principles of agency and trusts?

Yes, both principles are recognized as a matter of US law.

For instance, it is common to appoint an agent in connection with a loan or a trustee in connection with a bond. The agent or trustee, as applicable, may act on behalf of the lenders or secured parties or hold rights and other assets on for such lenders or secured parties.

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Are there any other notable risks or issues around lending?

Generally

Federal and state laws prohibit lenders from charging an unreasonably high interest rate or other unreasonable fees. Lenders who violate usury laws may incur civil or criminal penalties.

Standard form documentation

Credit agreements in the US are typically based on the agent's or lead lender's standard form. This may incorporate language recommended by the Loan Syndications and Trading Association, but there is no standard form documentation.

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Are there any other notable risks or issues around borrowing?

There are no other notable risks or issues around borrowing to be raised further to those outlined in preceding sections.

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Giving and taking guarantees and security

Are there any restrictions on giving and taking guarantees and security?

Below are some of the key areas affecting the giving of guarantees and security.

Capacity

It is important to check the law of the state in which the company is organized, as well as the constitutional documents of a company giving a guarantee or security to ensure it has an express or ancillary power to do so and there are no restrictions on the directors' powers that would be preventative.

Consideration

Many state statutes require that the guarantee be in furtherance of the company's purpose and that the company receive a benefit in exchange for providing such guarantee. This is often more difficult in the case of upstream or cross-stream guarantees or security provided by a subsidiary to its parent or sister company. The safe approach is often to have the members of the company approve the giving of the guarantee or security by resolution. Some state statutes also provide a safe harbor if the company and borrower are part of the same corporate group.

Insolvency

Guarantees and grants of security may be at risk of being set aside under US bankruptcy laws if the guarantee or security was granted by a company that was insolvent at the time of such grant and the company received less than reasonably equivalent value for the guarantee. Guarantees and security may also be challenged on other grounds relating to insolvency.

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What are common types of guarantees and security?

Common forms of guarantees

Guarantees can take a number of forms. A particular distinction worth remembering is between a guarantee of payment and a guarantee of collection.

Under a guarantee of payment, the guarantor is obligated to repay the lenders immediately upon default of the borrower. The lenders are not required to first take any action against the borrower. Guarantees of payment are customary in the US.

Under a guarantee of collection, the lenders must first exhaust all remedies against the borrower before they may make a claim under the guarantee. The lenders are only entitled to the shortfall not paid by the borrower.

Common forms of security

Under US law, personal property, fixtures, general intangibles and other certain types of collateral are governed by the Uniform Commercial Code (UCC) as adopted in the borrower's state of organization. Other types of collateral, including mortgages and motor vehicles, are governed by applicable state or federal laws, instead of or in addition to the UCC.

Under US law it is possible to grant security over all or a portion of the assets of a US borrower or guarantor.

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Are there any other notable risks or issues around giving and taking guarantees and security?

Giving or taking guarantees

Guarantees are typically considered secondary, and not primary, obligations.

Many legal defenses are available to guarantors which may invalidate the guarantor's obligations under the guarantee, including the invalidity of the underlying credit agreement or a change to the corporate structure of the borrower. However, in most cases, the lenders require the guarantor to waive these defenses, and doing so is typically permitted under applicable US law.

US state law typically requires that a guarantee be in furtherance of the guarantor's purpose and that the guarantor receive a benefit in exchange for providing such guarantee. This may be achieved if the company and borrower are part of the same corporate group.

Giving or taking security

A security interest is created and attaches to the company's property when the lender extends credit to the borrower and the borrower delivers to the lender a written agreement granting the security interest and describing the property.

Once created, the security interest needs to be properly perfected before it is valid against third parties. Perfection formalities are governed by the Uniform Commercial Code (UCC) as adopted in the borrower's state of organization and, with respect to real estate, by the real estate law of the state where real property is located. Perfection formalities can range from having the secured asset delivered to the security holder, filing a financing statement or mortgage or entering into a control agreement. Under the UCC, a lender who properly files a financing statement first typically has priority over other lenders, with certain exceptions.

Security documents granting a security interest in personal property collateral generally do not need to be notarized, but notarization may be required for real property in certain states.

There may be negative tax consequences to a US borrower if the loan is secured by all of the assets of its non-US subsidiary that is considered a 'controlled foreign corporation.'

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Financial regulation

Law and regulation

What are the main laws and regulations that apply to entities that are involved in finance and investments generally?

Generally

FEDERAL

Federal Deposit Insurance Act (FDI Act)

Federal Reserve Act

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

Volcker Rule (implementing section 619 of the Dodd-Frank Act)

Regulation W (implementing sections 23A and 23B of the Federal Reserve Act pertaining to restrictions on lending to affiliates)

12 US Code (USC) section 84 and 12 Code of Federal Regulations (CFR) section 32 (restrictions on lending limits)

Regulation O (restrictions on lending to insiders)

Bank Holding Company Act (BHC Act) (anti-tying rules)

Equal Credit Opportunity Act (ECOA) (fair lending)

Regulation B (implementing the ECOA)

Bank Secrecy Act

Securities Act of 1933 (Securities Act) and the Securities and Exchange Commission (SEC) rules thereunder

Securities Exchange Act of 1934 (SEA) and the SEC rules thereunder

Investment Advisers Act of 1940 (IAA) and the SEC rules thereunder

Investment Company Act of 1940 (ICA) and the SEC rules thereunder

STATE

Individual state laws and related state regulations apply.

Consumer credit

FEDERAL

Truth in Lending Act (TILA)

Regulation Z (implementing TILA)

STATE

Individual state laws and related state regulations, including licensing and compliance regimes apply.

Mortgages

FEDERAL

Fair Housing Act

Home Mortgage Disclosure Act (HMDA)

Regulation C (implementing the HMDA)

Truth in Lending Act (TILA)

Regulation Z (implementing TILA)

Real Estate Settlement Procedures Act (RESPA)

Regulation X (implementing RESPA)

TILA/RESPA Integrated Disclosure Rule (TRID)

STATE

Individual state laws and related state regulations, including licensing and compliance regimes apply.

Securities

BROKER-DEALERS/INVESTMENT ADVISERS (AS DEFINED IN THE INVESTMENT ADVISERS ACT OF 1940)

Federal

Securities Act and the SEC rules thereunder

SEA and the SEC rules thereunder

IAA and the SEC rules thereunder

ICA and the SEC rules thereunder

State

Individual State Securities ('blue sky') laws and related state regulations apply.

BROKER-DEALERS ONLY

Self-regulatory organizations

Financial Industry Regulatory Authority (FINRA) Rules

National Securities Exchange Rules (e.g. New York Stock Exchange, NASDAQ Stock Market)

Federal Reserve Board of Governors Margin Rules (Regulation T)

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Regulatory authorization

Who are the regulators?

Lending

FEDERAL

The Office of the Comptroller of the Currency (OCC) is an independent bureau within the US Treasury Department that charters, regulates, and supervises all national banks and thrift institutions and the federal branches and agencies of foreign banks in the US.

The Federal Deposit Insurance Corporation (FDIC) is a US government corporation that provides deposit insurance to depositors in US banks. It also examines and supervises certain financial institutions for safety and soundness, performs certain consumer-protection functions, and manages receiverships of failed banks.

The Federal Reserve Board of Governors (Federal Reserve) is the main governing body of the Federal Reserve System and is charged with overseeing the Federal Reserve Banks and helping to implement monetary policy in the US.

The Consumer Financial Protection Bureau (CFPB) is an independent US government agency that enforces consumer protection laws and regulations specific to the US financial sector. Its jurisdiction includes banks, credit unions, securities firms, payday lenders, mortgage-servicing operations, debt collectors, and other financial companies operating in the US.

The Federal Trade Commission (FTC) is an independent US government agency that enforces consumer protection laws and regulations.

The Financial Crimes Enforcement Network (FinCEN) is a bureau of the US Treasury Department that collects and analyzes information about financial transactions in order to combat domestic and international money laundering, terrorist financing, and other financial crimes.

STATE

State regulatory agencies regulate state-chartered banks and certain non-affiliates of federally chartered banks, as well as non-bank lenders.

Securities

FEDERAL

The US Securities and Exchange Commission (SEC) is the primary regulator of the US securities markets and oversees the key participants in the securities world, including securities exchanges, brokers and dealers, investment advisors and mutual funds.

The Financial Industry Regulatory Authority (FINRA) is an independent, not-for-profit organization authorized by Congress to protect investors and market integrity through regulation of broker-dealers.

National Securities Exchanges (acting in the role of self-regulatory organizations) are securities exchanges that have registered with the SEC under section 6 of the Securities Exchange Act of 1934.

The US Commodity Futures Trading Commission (CFTC) is an independent US government agency that polices the derivatives markets and futures and swaps markets to lower the risk to the public.

STATE

State securities regulators enforce 'blue sky' laws, which cover many of the same activities the SEC regulates, but are confined to securities sold or persons who sell them within each state.

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What are the authorization requirements and process?

Lending

The need for authorization to offer credit products varies depending on the type of product (consumer or commercial) and the type of collateral securing the product (real estate or non-real estate). Most product offerings require prior authorization. Certain entities (e.g. savings associations, credits unions, and banks) are authorized to lend on a national basis. Other non-bank lenders are required to obtain individual state authorization, which generally permits lending to borrowers located only in that state.

In most cases, the process for obtaining the requisite authorization is initiated with an application that typically includes identification of control parties and management, disclosure of any negative civil, criminal, and regulatory history, meeting capital and/or surety bond requirements, providing financial statements, business plans, and organizational charts, and related compliance obligations as discussed below.

Broker-dealers

Obligations include:

- registration of the entity with the Securities and Exchange Commission (SEC) as a broker-dealer;
- registration of the entity in each state in which it 'does business' (by having a physical presence in the state or by engaging in business with persons inside the state from outside the state);
- membership in a registered national securities association, i.e. the Financial Industry Regulatory Authority (FINRA) – the only exception is for broker-dealers that do no public customer business and only engage in activities on a national securities exchange of which they are a member, who may in some cases avoid FINRA membership;
- registration with FINRA of each individual engaged in the broker-dealer's securities business (except for clerical and administrative personnel) and with each state in which the individual does business – as with broker-dealer firms, registration by individuals working for firms whose only business is on the floor of an exchange may in some cases be done through that exchange;
- registration of each individual only after successful completion of one or more proficiency examinations relevant to the person's business; and
- fees and charges generally for each of the above items.

Investment Advisers (as defined in the Investment Advisers Act of 1940)

Obligations include:

- registration of the entity with the SEC as an 'Investment Adviser' (as defined in the Investment Advisers Act of 1940); or
- for certain small Investment Advisers (determined by assets under management), registration instead with the particular state in which they do business.

There are no self-regulatory organizations for investment advisers. Investment Adviser personnel do not have to register with the SEC; however, they may be required to register with certain states in which they do business and take a proficiency exam in connection therewith.

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What are the main ongoing compliance requirements?

Lending

Compliance requirements vary depending on the type of lender (bank or non-bank), the regulatory agency from which that entity seeks authorization, and the products being offered. Nevertheless, common requirements include periodic financial reports to the regulator, assessment of management, compliance with Know your Customer (KYC) and anti-money laundering (AML) rules and regulations, compliance with applicable interest rate caps, fee limitations, disclosure obligations, and limitations or prohibitions on referral fees.

Broker-dealers

Specific requirements include:

- continually updating relevant information provided at the time of registration – for both the firm and its registered individuals;
- supervision of each business activity and each registered individual by a qualified (by examination) supervisor/principal pursuant to detailed written supervisory procedures;
- annual review and certification of adequacy of the broker-dealer's supervisory structure and procedures by the broker-dealer's CEO or an equivalent senior officer;
- regular (annual or bi-annual) regulatory examinations by the Securities and Exchange Commission (SEC), Financial Industry Regulatory Authority (FINRA) and, in some cases, state regulators;

- detailed procedures for opening customer accounts including obtaining detailed background and financial information for each customer, including required AML-related information;
- maintenance of accurate books and records relating to each part of the business, including transactions, finances, and customer /client information in prescribed formats and for prescribed periods;
- requirements for protection of confidential customer/client information and material non-public information;
- supervision, review and retention of all communications with the public (including all electronic communications);
- detailed minimum net capital requirements and regular reporting of net capital calculations and immediate notification and/or cessation of business requirements if capital falls below prescribed amounts;
- detailed requirements for protecting customer securities and funds;
- requirement to establish, maintain and enforce detailed cybersecurity, business continuity and disaster recovery procedures; and
- continuing education requirements for each registered individual.

Investment Advisers (as defined in the Investment Advisers Act of 1940)

Specific requirements include:

- continually updating relevant information provided at the time of registration;
- supervision of each business activity and each employee pursuant to detailed written compliance procedures;
- annual review of the Investment Advisers' written policies and procedures designed to prevent violations of the Investment Advisers Act of 1940 (IAA) and the rules thereunder;
- periodic regulatory examinations by the SEC and/or state regulators;
- developing and maintaining procedures with respect to political contributions;
- maintenance of accurate books and records relating to each part of the business;
- requirements for protection of confidential customer/client information and material non-public information;
- requirement to deliver a brochure and one or more brochure supplements to each client or prospective client that contains all information required by Part 2 of SEC Form ADV (a uniform form used by Investment Advisers to register with both the SEC and state securities authorities);
- requirements for prevention of misuse of material non-public information;
- requirement to establish, maintain and enforce a detailed code of ethics;
- requirement to file Form PF (reporting form for 'investment advisers to private funds'), providing data intended to facilitate monitoring of systemic risk private fund (applies to all private funds including private equity funds, hedge funds and liquidity funds);
- requirement to establish, maintain and enforce detailed cybersecurity, business continuity and disaster recovery procedures;
- compliance with rules relating to advertising and marketing materials; and
- compliance with requirements relating to custody of client assets.

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What are the penalties for failure to be authorized?

Lending

Penalties for violations of law can include cease and desist orders, civil monetary fines, enforcement actions, prescriptive orders, and even imprisonment depending on the regulator and the nature of the infraction. In some cases, if an entity is lending without authorization to do so, the loan will be considered void and unenforceable or the lender will be enjoined from collecting interest on the loan.

Securities

Examples of penalties for failure to obtain authorization are, for broker-dealers:

- cease and desist orders;
- monetary fines and penalties;
- disgorgement of fees, compensation or profits;
- potential rescission of any transaction intermediated by an unlicensed entity or person; and
- willful violations of the Securities Exchange Act of 1934 (SEA) may be prosecuted as criminal violations, with large fines to entities and potential incarceration for individuals.

And for Investment Advisers (as defined in the Investment Advisers Act of 1940):

- cease and desist orders;
- monetary fines and penalties;
- injunctions; and
- willful violations of the Investment Advisers Act of 1940 (IAA) may be prosecuted as criminal violations, with large fines to entities and potential incarceration for individuals.

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Regulated activities

What finance and investment activities require authorization?

Lending

It will depend on the jurisdiction in which the products are being offered.

Broker-dealers

Any activity involving the offer or sale of securities, or the solicitation of an offer to purchase securities requires registration, including retail and institutional brokerage, proprietary trading and market making, and M&A activity that involves transactions in securities (as opposed to pure asset sales).

Investment Advisers (as defined in the Investment Advisers Act of 1940)

Engaging, for compensation, in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities.

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Are there any possible exemptions?

Lending

It will depend on the jurisdiction in which the products are being offered.

Broker-dealers

FEDERAL

There are certain very limited exemptions from the broker-dealer registration requirements, including:

- exemptions for officers and employees of issuers engaged in the offer and/or sale of their employers' own securities (subject to strict limitations including compensation restrictions);
- exemptions for certain non-US broker-dealers operating from outside the US, engaging in certain limited activities with certain institutional investors (in most cases, the participation of a US registered broker-dealer in key parts of the process is required); and
- other exemptions provided from time-to-time by the Securities and Exchange Commission (SEC) through 'no-action' letters and similar relief.

STATE

A number of states have exemptions from registrations for broker-dealers and their individual personnel that engage in limited activities from outside the state with certain types of investors (in most cases institutional investors only) in the state. The existence, terms, and conditions of each state's exemption may differ.

Investment Advisers (as defined in the Investment Advisers Act of 1940)

The following Investment Advisers are exempt from authorization requirements:

- any Investment Adviser (other than an Investment Adviser who acts as an Investment Adviser to any private fund), all of whose clients are residents of the State within which the Investment Adviser maintains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange;
- any Investment Adviser whose only clients are insurance companies;
- any Investment Adviser that is a private fund advisor, i.e. an advisor solely to private funds with less than USD150 million in assets under management in the US;
- any Investment Adviser that is a venture capital advisor;
- any Investment Adviser that is a charitable organization as defined in the Investment Company Act of 1940 (ICA), or is a trustee, director, officer, employee, or volunteer of such a charitable organization acting within the scope of such person's employment or duties with such organization, whose advice, analyses, or reports are provided only to one or more of the following:
  - any such charitable organization;
  - a fund that is excluded from the definition of investment company under the ICA; or
  - a trust or other donative instrument, or the trustees, administrators, settlors (or potential settlors), or beneficiaries of any such trust or other instrument;
- any plan described in section 414(e) of the US Internal Revenue Code of 1986 (Revenue Code), any person or entity eligible to establish and maintain such a plan under the Revenue Code, or any trustee, director, officer, or employee of or volunteer for any such plan or person, if such person or entity, acting in such capacity, provides investment advice exclusively to, or with respect to, any plan, person, or entity or any company, account, or fund that is excluded from the definition of an investment company under section 3(c)(14) of the ICA;
- any Investment Adviser that is registered with the Commodity Futures Trading Commission (CFTC) as a commodity trading advisor whose business does not consist primarily of acting as an Investment Adviser, as defined in the Investment Advisers Act of 1940 (IAA), and that does not act as an Investment Adviser to certain registered investment companies or business development companies;
- any Investment Adviser that is registered with the CFTC as a commodity trading advisor and advises a private fund, provided that, if after the date of enactment of the Private Fund Investment Advisers Registration Act of 2010, the business of the advisor should become predominately the provision of securities-related advice, then such advisor must register; and
- any Investment Adviser, other than any entity that has elected to be regulated or is regulated as a business development company, who solely advises certain small business investment companies.

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Do any exchange controls or other restrictions on payments apply?

Securities transactions effected by US broker-dealers, including transactions in non-US securities, must be reported by the executing broker-dealer to Financial Industry Regulatory Authority (FINRA). Any transaction reported to FINRA must be reported in US dollars, regardless of the currency in which the transaction occurred. The methodology employed by the broker-dealer for currency conversion is left to the broker-dealer; however, the methodology must be reasonable and the broker-dealer must document its practice and employ the same method consistently.

Foreign exchange transactions are generally effected through futures commission merchants subject to the oversight of the Commodity Futures Trading Commission (CFTC) pursuant to the US Commodity Exchange Act. However, forex securities transactions effected by securities broker-dealers are subject to FINRA oversight. In an effort to protect retail investors, FINRA from time to time issues cautionary bulletins to investors about the risks of forex transactions and in 2009 proposed to limit the leverage ratio that a FINRA-member broker-dealer could offer a retail forex customer. The proposed rule was later withdrawn.

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What are the rules around financial promotions?

Rules

Offers of securities and other financial products are subject to detailed requirements and restrictions imposed by the Securities Act of 1933, Securities Exchange Act of 1934 (SEA), Investment Advisers Act of 1940 (IAA) and Investment Company Act of 1940 (ICA), as well as relevant Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) rules and regulations thereunder, including without limitation:

- registration requirements for offered securities;
- registration and licensing requirements for persons involved in such activities;
- requirements with respect to the content of prospectuses, offering memoranda and other documents;
- supervision and retention requirements; and
- general antifraud prohibitions.

Offers of financial services are likewise subject to detailed requirements imposed by the foregoing statutes, rules and regulations, including:

- detailed requirements for content, retention and supervision of communications with clients/customers and potential clients /customers;
- advertising regulations;
- requirements for providing investment research; and
- general antifraud prohibitions.

Exemptions

The relevant requirements and restrictions imposed by the foregoing statutes, rules and regulations include various exemptions and exceptions, which generally are based on the nature of the offered products or services, the intended target audience, the type of communication and specific content thereof, and a number of other factors.

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Entity establishment

What types of legal entity are generally used to undertake financial or investment activity?

Lending

It will depend on the nature and purpose of the intended activities and any applicable laws, regulations, or jurisdictional constraints.

Securities generally

Most broker-dealers and Investment Advisers (as defined in the Investment Advisers Act of 1940) are either corporations or limited liability companies (LLCs). Certain firms may operate as general or limited partnerships but this is not common today.

Funds

Funds are often established as LLCs or limited partnerships although other structures are used depending on taxation and regulatory analysis, amongst other things.

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Is it possible to conduct lending or investment business through a branch or establishment?

Lending

Generally, yes, subject to laws and regulations regarding branches, which vary depending on the regulator and jurisdiction.

Securities

Broker-dealers commonly operate through branch offices and, in some cases, satellite offices not treated as branch offices (including certain home offices of individual registered representatives of broker-dealers). Each such office is subject to detailed rules regarding staffing, supervision, oversight by home office, recordkeeping, signage and other matters.

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FinTech

FinTech products and uses

What are the most common technology products and FinTech applications used or being developed in the finance and investment marketplace?

Online lending (e.g. peer-to-peer funding platforms and marketplace lending)

A variety of online lending and similar platforms currently exist in the US. While each of these platforms have distinct business models and focus on different markets and asset classes, they can most easily be categorized as either 'balance sheet lenders' (i.e. those that invest their own money in the assets they originate) or 'peer-to-peer (P2P) lenders' (i.e. those that create and manage a platform on which investors in credit products can provide credit to either individuals or businesses seeking credit).

Balance sheet lenders make money the old-fashioned way – by earning yield on the products they originate, which after deducting losses, cost of funds and administrative costs, should result in a profit.

P2P lenders on the other hand, typically do not take balance sheet risk and instead earn a fee for every transaction executed on the platform. Both models use technology extensively and in novel ways for both customer acquisition, underwriting and portfolio management. Also, online lenders generally do not have a bank charter, and thus are unable to take deposits to fund their business (although some online lenders recently applied for an Federal Deposit Insurance Corporation (FDIC)-insured industrial loan company charter).

Online lenders address most forms of traditional bank funding products. Recently, products have included:

- credit cards;
- consumer loans (secured and unsecured);
- merchant cash advances;
- student lending products;
- small business lending;
- residential property and commercial property mortgage lending; and
- multiple forms of factoring.

It is likely that the volume of lending in these product areas as well as further and additional product areas will significantly increase over the coming years, as financing becomes more readily available to support this sector.

HOW ARE MARKETPLACE LENDING PLATFORMS FUNDING THEMSELVES?

Balance sheet online lenders, without a bank charter, raise debt and equity from both private and public sources to finance their asset originations, and also establish whole-loan sale programs whereby institutional investors purchase loans shortly after origination (thus earning the originator an immediate premium on the asset sold and relieving the originator from the burden of financing the asset through maturity). As these balance sheet online lenders are becoming more mature, they are also accessing funds via the traditional securitization markets, in both rated and unrated deals.

P2P lenders, on the other hand, originally conceived of a model whereby the 'investor side' of the platform would provide all necessary financing. However, as the P2P models have evolved, many platforms have become more reliant on the stability and cost-effectiveness of institutional financing, often executed through committed whole-loan sale programs whereby the institutional investors agree to buy newly-originated assets meeting certain specified criteria either on a one-off basis or on a periodic schedule. These investors then leverage the assets themselves in multiple ways, including with traditional warehouse and term financing and through the securitization markets.

ISSUES FOR STARTUP ONLINE LENDERS

Most startup online lenders initially raise equity to establish the business and fund initial originations, and thereafter raise private debt financing as they continue to build the business. Most of these debt facilities are structured as special purpose vehicle (SPV) financings, whereby the newly-originated asset is sold to the SPV (a subsidiary of the originator) and then the lender makes a loan to the SPV at a pre-agreed percentage of the principal balance of the asset (for instance, 85%). Thereafter, the SPV is required to maintain the 'borrowing base' at all times, lest it default on its obligations to the lender. First facilities tend to be quite expensive and advantageous to the lenders; but as the originator grows, and its performance track record increases, the cost of funding normally drops over successive debt facilities.

Depending on the model used, the particular asset class, and whether the online lender partners with a bank, the lender must also consider any license or authorization to lend that applies. Such requirements are driven by the state or location of the borrower in most cases, which unfortunately dictates a fairly extensive multi-state assessment for online lenders seeking to provide credit on a national basis.

Blockchain, smart contracts and cryptocurrencies

WHAT IS BLOCKCHAIN?

Blockchain is a distributed ledger technology in which data is recorded on a P2P network, using pre-agreed consensus algorithms to process changes in the data. Data is stored in 'blocks' that, as transactions are processed, connect to form a 'chain'.

Specialist users on the system apply advanced computing software to identify time stamped blocks, verify the accuracy of the blocks using sophisticated algorithms and add the verified blocks to the chain. As the number of participants increases, the replication of the data over a wider base makes it harder for any person to alter the data in the chain. Any attempted addition or modification to the information on a block needs to be approved by a consensus of the users in the network following a verification process that requires significant effort and expense, which makes it practically impossible to insert fake transactions into a block.

WHAT ARE SMART CONTRACTS AND DECENTRALIZED AUTONOMOUS ORGANIZATIONS (DAOS)?

Developments in blockchain are also providing an ability to transfer and rely on instructions set forth in so-called 'smart contracts'. Smart contracts are essentially pre-written computer codes which are stored and replicated on distributed ledger platforms such as blockchain. Execution takes place over the network, eliminating the need for intermediary parties to confirm the transaction, leading to self-executing contractual provisions. These contracts can be as simple as moving a balance from one account to another, or advanced, more-complex interactions with the outside world using so called 'Oracles'. With Oracles the contract code consults with a service outside of the blockchain network to make a decision. This may entail receiving a confirmation that an event has occurred, such as payment, which automatically executes a further step in the contract, such as the transfer of an asset, which might be in digital form or by delivering instructions to a person or warehouse to release the asset for delivery.

DAOs are essentially online, digital entities that operate through the implementation of pre-coded rules. These entities often need minimal to zero input into their operation and they are used to execute smart contracts, recording activity on the blockchain. DAOs can be particularly challenging to regulate, depending on their software engine, the nature of the transactions they are completing or other unique features. Questions of ownership and responsibility for resulting acts of DAOs can also be brought to question if any technical issues arise with their operation.

WHAT IS A CRYPTOCURRENCY?

Cryptocurrency is the common name given to digital representations of value. Unlike fiat currencies, cryptocurrencies are not created or sanctioned or backed by any governmental entity. Instead, they are usually issued by entities as a means of exchange and can be transferred, shared or traded economically. The oldest and best-known cryptocurrency is bitcoin, although many other cryptocurrencies now exist. For example, the most widely-known alternatives to bitcoin include ether and litecoin. Cryptocurrencies are now actively traded with a large developing infrastructure for holding, pricing and exchanging them.

Initial coin offerings and token-based products

WHAT IS AN INITIAL COIN OFFERING (ICO)?

ICOs are offerings of digital currency (tokens) for sale to the public or to a set of users, often as a means of raising funds for a new blockchain or cryptocurrency venture. ICOs vary in structure and purpose. Some ICOs offer tokens to customers or suppliers as a form of loyalty program, while others offer network users access to the network or purchasing power as to the issuer’s business. It is essential to examine the legal and regulatory basis for any ICO, as tokens may constitute securities, commodities, money transmission devices, or otherwise raise legal concerns.

The nature of the business and the purpose and structure of the token offering will typically be set out in a white paper available to potential purchasers.

The Securities and Exchange Commission and several other governmental authorities in the US are actively monitoring ICOs.

Artificial intelligence and robo advisory systems

Automated financial advice tools, also known as 'robo advisors', are software tools driven by artificial intelligence (AI) that provide a variety of investment advisory services, from portfolio selection to personal finance planning. The systems are generally operated on a platform /personal dashboard basis; a user can input a set of personalized data to be processed by the AI algorithms, which produce optimized outcomes around specified parameters. Robo advisors are particularly important to investment advisors and broker-dealers, including those serving younger clientele. The Financial Industry Regulatory Authority (FINRA) reported in December 2016 that 38% of investors between the ages of 18 and 34 have used robo advisors, although their popularity has been expanding among all age groups and classes of investors.

Robo advisors in the US must comply with the securities laws applicable to any other type of investment advisor, including state or federal registration obligations. These authorities have published various guidance concerning robo advisors, both for the benefit of investment advisors offering robo-advisor services and their clients. Key considerations relevant to anyone involved in this space include:

- decreased human involvement;
- the information provided to create recommendations;
- the approaches (from style to products to risk profile) that the robo advisors use; and
- the fees charged.

Data analysis and cloud computing

Cloud computing enables delivery of IT services through internet-based tools and applications, rather than direct connection to a physical server. Cloud-based storage makes it possible to save masses of data to remote servers, accessible through the internet rather than by way of a physical connection. With the vast data processing and storage capabilities offered by cloud computing technology and virtually no infrastructure barriers to entry, there are a number of applications in building and running FinTech businesses and the technology has had a significant impact in recent years.

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Are there any restrictions, specific laws, regulations or procedures that apply to FinTech products?

General financial regulatory regime

In the US, financial services related activities are regulated under a variety of federal and state laws.

FEDERAL

At the federal level, the key banking regulators are the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of Comptroller of the Currency (OCC), with the National Credit Union Administration (NCUA) regulating credit unions.

The Securities and Exchange (SEC) commission regulates securities issuers, investment companies, broker-dealers, investment advisors, and certain others involved in the securities industry.

The Commodity Futures Trading Commission (CFTC) regulates swap execution facilities, derivatives clearing organizations, designated contract markets, swap data repositories, swap dealers, futures commission merchants, commodity pool operators, and other entities.

The Financial Crimes Enforcement Network (FinCEN) of the US Department of the Treasury regulates money services businesses, including currency dealers, check cashers, money transmitters, and others.

STATE

In addition, most US states have separate laws that regulate these industries, as well as other ancillary financial services such as various types of consumer lending or loan brokering activities. Notably, the insurance industry is regulated at the state level.

Regulation of online lenders

ONLINE LENDERS

Online lenders are regulated by all 50 states and, in some capacities, at the federal level. Depending on the state and the asset class, licenses could be required for lending, collection/servicing or money transmission services.

Startup online lenders should consider the cost of these compliance activities as they conduct their initial equity raise(s), as the ability to raise subsequent debt financing will depend upon the prospective lenders being reasonably satisfied that the originator is in compliance with all applicable lending and other laws and has all necessary licenses.

Regulation of money service businesses

A 'money services business' (MSB) generally includes any person doing business, whether or not on a regular basis or as an organized business concern, in one or more of the following capacities in the US:

- currency dealer or exchanger;
- check casher;
- issuer of traveler's checks, money orders or stored value;
- seller or redeemer of traveler's checks, money orders or stored value; or
- money transmitter.

At the federal level, an activity threshold of greater than USD1,000 per person per day applies to the first four categories, but no activity threshold applies to money transmitters. Activities performed by banks or SEC or CFTC registrants are excluded from MSB registration. In addition, there is a limited exemption for persons that sell goods or provide services (other than money transmission services) and only transmit funds as an integral part of that sale of goods or provision of services.

An MSB must register with FinCEN. Among other things, MSBs must also implement a risk-based compliance program designed to detect and prevent money laundering, terrorist financing, and other illicit activities. In addition, most US states require licenses to perform these activities in their state, which can take more time and entail more resources to obtain. Notably, exemptions available at the federal level do not always translate to exemptions from state licensure.

FinCEN has stated that certain virtual currencies may trigger money transmission regulation. While users of virtual currencies are not money transmitters, those who issue virtual currency or put it into circulation and have the authority to redeem or withdraw it from circulation may be regulated as an 'administrator'. In addition, if a business exchanges virtual currency for fiat currency or other virtual currency, the business may be regulated as an 'exchanger'.

Application of data protection and consumer laws

US privacy law is a complex patchwork of privacy laws and regulations addressing specific industries, communications media, or marketing methods, supplemented by a backdrop of federal and state prohibitions against unfair or deceptive business practices and state laws that specifically address privacy and security of personal information.

The US has not adopted a comprehensive federal privacy and data security law akin to the UK Data Protection Act of 1998 and related laws. Instead, the US has implemented a sectoral approach to data privacy, promulgating regulations in areas that it deems to be of specific concern, including:

- financial data;
- credit data;
- background checks;
- health information;
- telecommunications companies;
- video rental records (which may include certain video streaming services);
- driver's license information and history;
- children's information; and
- marketing.

Outside of sector-specific laws, certain privacy protections are afforded by the general prohibition against unfair and deceptive trade practices, which has been interpreted to require appropriate notice to consumers about privacy or other practices, including the information collected, obtaining consent to sharing of sensitive data, or the failure to abide by representations made in privacy policies (including those about information security).

In addition, each state has its own consumer privacy and protection framework. Many state laws address privacy-related issues, such as requirements for data security, compliance with the Payment Card Industry Data Security Standard (PCI-DSS), storage of data, privacy of health data, disposal of data, privacy policies, appropriate use of social security numbers and data breach notification, among other things. States also have consumer protection laws that seek to protect consumers against unfair and deceptive trade practices, and state attorneys general typically enforce these laws against businesses (though, in some states a private right of action is available against companies that violate state consumer protection laws). State privacy laws typically track the location of the data subject or the consumer, regardless of where the business is located.

In the US, companies should generally:

- develop, implement and follow a privacy policy;
- implement appropriate security measures; and
- in the event of a breach of any unencrypted personal data, comply with US data breach notification laws.

Money laundering and regulated regulations

Money laundering generally refers to concealing or disguising the existence, illegal origins, or illegal application of criminally derived income so that such income appears to have legitimate origins or constitute legitimate assets. Money laundering is typically associated with funds or proceeds derived from illegal activities, such as tax violations, environmental crimes, foreign corruption, healthcare offenses, fraud, drug trafficking, arms smuggling, prostitution, racketeering, or terrorism.

There are numerous federal anti-money laundering (AML) and combating the financing of terrorism (CFT) laws in the US, including the Money Laundering Control Act of 1986, criminal money laundering statutes contained in 18 U.S.C. §§ 1956 and 1957, the amendment to the Bank Secrecy Act (BSA), and certain provisions of the Uniting and Strengthening America by Providing Appropriate Tools to Restrict, Intercept and Obstruct Terrorism Act of 2001 (USA PATRIOT Act).

Individuals convicted of AML/CFT offenses can face imprisonment, as well as criminal and/or civil penalties. Companies that violate AML /CFT laws can face administrative, criminal, and civil penalties depending on the circumstances. Enforcement agencies may also seize and forfeit funds and property tainted by AML/CFT violations.

FinCEN is responsible for administering the BSA and also is empowered to bring civil enforcement actions for BSA violations. In addition to the federal regime, several US states have promulgated their own AML/CFT laws and regulations.

All US persons are prohibited from engaging in AML/CFT violations and transactions involving sanctioned jurisdictions or persons. In addition, US 'financial institutions' – which include not only traditional banks but also other organizations such as MSBs, casinos, pawn shops and many state-regulated financial institutions – must take additional steps such as:

- filing currency transaction and suspicious activity reports; and
- establishing and implementing written AML/CFT programs.

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What type of funding arrangements and incentives are available to FinTech businesses?

Early stage

SEED INVESTMENT

In the US, initial outside investment in FinTech businesses is usually provided by private placements of securities sold to persons with a preexisting substantive relationship to the company or its founders, such as sophisticated friends or family or persons with whom they have had prior business dealings. Seed funding may also be provided by early stage 'angel' investors or incubator or accelerator programs. Investments usually take the form of equity or instruments convertible into equity. Seed funding is often used to fund the establishment and early growth of the business before larger investment is available. The investing individuals may also provide know-how and expertise to assist in the company's development. The seed investors would typically not require the same controls over the business as, for example, venture capital (VC) investors.

CROWDFUNDING AND 'ACCREDITED INVESTOR CROWDFUNDING'

In the US, the sale of securities via crowdfunding has been underused, primarily due to the costs of compliance. For example, it requires using a registered broker-dealer or a registered 'funding portal', thereby prohibiting direct sales. It also requires providing specified disclosures and complying with many other requirements, including a USD2,000 limitation on the amount from any investor and a USD1 million limitation on the amount that can be raised. This resulting cost of using the exemption, together with the perceived stature of the businesses resorting to this exemption and concerns that its use could limit future financing options or M&A transactions, has resulted in low uptake of crowdfunding in the US.

The recent advent of Initial Coin Offerings (ICOs), token generation events and other blockchain-enabled financing structures has resulted in increased use of a relatively new technique sometimes referred to as 'accredited investor crowdfunding'. In short, this involves using general solicitation to locate 'accredited investors' (as defined in Rule 501 of Regulation D), provided that sales only occur to those who the issuer has taken reasonable steps to verify are accredited investors. These steps generally involve reviewing independent documentation (not just self-certification by the investor), such as reviewing Forms W-2, tax returns, bank and brokerage statements, or confirmatory letters from investment advisors, broker-dealers, accountants, or lawyers. Other conditions apply, including that the securities sold are 'restricted securities' subject to resale limitations.

Venture capital and debt

VC funding is usually more suitable for FinTech companies that, while still early-stage, have more established businesses. VC investors usually acquire equity in the form of preferred stock, which may include preferences in payment on liquidation, dividends, voting, or other matters. Depending on the amount of investment, VC investors might also require special governance rights, such as the right to designate a director or to observe the board, or certain co-sale, first refusal, or preemptive rights. Many VC investors specialize in particular sectors such as FinTech and therefore can provide tailored business support to FinTech companies.

VC investors include VC funds, which are special funds organized for the purpose of private investing. They may also include corporate VC, where a corporation has formed a fund for deploying investment dollars or making strategic or research and development (R&D) investments.

An additional funding option is venture debt. For example, the lender might provide the company a three-year term loan secured against a company's assets or revenues. The loan may also include an equity component for the lender. Many venture debt providers only invest in companies that have already received VC investment.

Warehouse and platform funding

Warehouse financing is a primary means of financing portfolios of FinTech assets. These facilities are most often structured as a loan to a bankruptcy-remote special purpose vehicle that is a newly-formed subsidiary of the originator.

Senior bank debt and capital markets funding

SENIOR BANK DEBT

Once a FinTech company is established and has a track record, bank debt becomes a more viable source of funding, either on a secured or unsecured basis depending on the creditworthiness and asset base of the business. In contrast to capital markets funding which is often covenant-lite, bank funding will generally involve the imposition of financial covenants and controls that will apply over the life of the facility. Bank finance may be particularly important for working capital, overdraft, accounts management and general liquidity purposes.

CAPITAL MARKETS FUNDING

When a company has grown to a sufficient size, an Initial Public Offering (IPO) may be a way to raise funds. Typically, an IPO will include listing the company’s shares on a national securities exchange, such as the New York Stock Exchange or Nasdaq. Financial and technology sector companies are staples of the US capital markets, consistently representing a meaningful portion of US IPOs. In the last 12 months, technology companies have represented approximately 20%, and financial services companies have represented about 11%, of US IPOs.

As described above, capital markets securitizations are also used by more mature originators as another source of liquidity.

Incentives and reliefs

To encourage early-stage investment in small, active businesses, section 1202 of the Internal Revenue Code (IRC) allows a non-corporate shareholder to exclude from gross income gain up to the greater of:

- USD10 million; or
- 10 times the adjusted basis of the investment that results from the sale or exchange of qualified small-business stock.

A qualifying small business must be a US C corporation whose aggregate gross assets immediately following the issuance of shares do not exceed USD50 million. In addition, the shareholder must have acquired the shares at their original issuance and then held them for at least five years.

A startup company may elect to deduct certain 'startup expenditures' incurred before the business is established over the 180-month period beginning with the month in which the active trade or business begins. A 'startup expenditure' generally means certain amounts paid or incurred in connection with either investigating or creating an active trade or business.

Taxpayers can also avail of R&D tax credits under section 41 of the IRC, for expenses stemming from qualifying research activities. The available credit ranges from 14%-to-20% of qualifying expenses over a fixed base amount. Certain companies unable to fully use the tax credit due to startup losses, may be eligible to choose to apply up to USD250,000 of the research credit against payroll tax liabilities.

Section 199A was newly enacted as part of the Tax Cuts and Jobs Act of 2017. Under this provision, owners of sole proprietorships, partnerships, S corporations and some trusts and estates may be eligible for a qualified business income (QBI) deduction for tax years beginning after 31 December 2017. Section 199A permits eligible taxpayers to deduct up to 20% of their QBI, plus 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income. QBI is the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business, including income from partnerships, S corporations, sole proprietorships, and certain trusts. Unless Congress decides to extend it, Section 199A will not apply to taxable years beginning after 31 December 2025.

Finally, many states have provided tax incentives to attract startup activity. These range from income tax credits to real property tax abatement for new office space.

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Portfolio sales

Loan transfers and portfolio sales

What are common ways of buying and selling loans?

Buying and selling loans is customarily done in an over-the-counter market. The most common ways of selling loans are by assignment and participation.

Assignment

An assignment is a transfer of rights and obligations and creates direct contractual rights between the borrower and the assignee. Credit agreements typically require the consent of the borrower to effectuate an assignment.

Participation

A participation is a transfer of the economic interest in a loan without changing the legal relationship between the existing parties. Credit agreements typically permit participations without the consent of the borrower. Loan transfers are commonly documented using standard form contracts made available by the Loan Syndications and Trading Association.

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What are the main considerations when transferring a loan and related security?

There are a number of issues to consider before transferring a loan. Below are some of the key considerations.

Lender eligibility

Credit agreements typically specify eligibility requirements for transferees (a borrower may also have the right to specify certain entities who are disqualified lenders, and loans may not be assigned to such entities).

Minimums

Credit agreements typically specify that assignments must be in a certain minimum amount, though assignments to affiliates are sometimes considered in the aggregate.

Transfer fees

Credit agreements typically require transfer fees be paid to the agent.

Consent

A transfer typically requires the consent of the borrower and the agent.

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Projects

Financing / investing in energy / infrastructure

To what extent are energy and infrastructure assets publicly or privately owned?

Generally

Infrastructure assets in the US are both publicly and privately owned. Traditionally, government entities own and operate most roads and bridges, water supply and wastewater facilities as well as the interstate passenger rail system known as Amtrak. Most energy infrastructure, rail lines and landline and cellular telecommunications networks are privately owned but are subject to regulation by federal, state and local government entities.

Significant attention has been focused in recent years on the state of infrastructure assets in the US. At both the state and federal level, there have been initiatives with respect to assets traditionally owned by public authorities to encourage private investment or to establish public-private partnerships used successfully in many other jurisdictions. For example, at least 33 states and Puerto Rico have enacted laws permitting the use of such public-private partnerships for highway and bridge projects. Also, in 2014, the federal government launched the Build America Investment Initiative which was designed to expand the market for public-private partnerships, among other things.

Energy

Utility-scale electric generation facilities in the US are owned primarily by traditional regulated utility companies and independent power producers both of which are privately owned. Regulated utility companies provide retail electric service directly to residential and industrial customers. Independent power producers sell at wholesale to regulated utility companies, into the open market or directly to industrial customers. Transmission systems in the US are also owned primarily by regulated utility companies.

There are also numerous consumer-owned, not-for-profit electric cooperatives as well as public municipal utilities that provide electric or transmission services on a retail and wholesale basis. In addition, certain generating assets are owned by one of the Department of Energy's four power marketing administrations and the Tennessee Valley River Authority. These generation assets are primarily hydropower or nuclear power facilities. In addition to utility-scale generation projects, sponsors in the US are developing residential and industrial rooftop and small-scale solar facilities as well as wind and gas-fired units. Development of both small and large-scale energy storage units is also increasing in the US.

The electric transmission systems and regional wholesale electricity markets in the US are controlled by independent system operators (ISO) within a single state or regional transmission organizations (RTO) across multiple states. RTOs and ISOs are not-for-profit organizations formed at the direction of the Federal Energy Regulatory Commission with the goal of providing open access to wholesale markets and available transmission.

Electric generation and transmission companies are regulated by the Federal Energy Regulatory Commission as well as a public utility commission at the state-level. Retail utility companies are subject to rate regulation designed to provide a reasonable return but limit costs to consumers. Interconnection with a transmission system is conducted pursuant to a standardized application process in each applicable state or region.

Energy policy is established by the federal government through the Department of Energy. Certain energy assets are also subject to regulation by the US Environmental Protection Agency and similar state agencies based on the impact on the environment and animal species and the treatment of hazardous materials. Nuclear plants are regulated by the Nuclear Regulatory Commission.

The production and transportation of oil and gas in the US is conducted primarily by private companies or municipalities. Pipelines throughout the US allow the transportation of oil and gas from production sources and import terminals to end-users or processing facilities. The Federal Energy Regulatory Commission also regulates the operation of oil and gas pipelines and related processing and import facilities.

Telecoms infrastructure

Private telecommunications companies provide wireless and wire-based services directly to consumers in the US. Many telecommunication companies are public companies with shares traded on the US stock market. The telecommunications industry in the US is dominated by several large players. The Federal Communications Commission is the primary regulator. Companies are subject to a complex regulatory scheme including licensing requirements.

Transport infrastructure

Freight rail in the US includes seven major carriers and dozens of smaller railroads all of which are privately owned. These companies own most of the tracks and related infrastructure.

The National Railroad Passenger Corporation or Amtrak is a for-profit corporation subsidized by the US, state and local governments. It was created by Congress pursuant to the Rail Passenger Service Act of 1970. It provides passenger rails services to 46 states and the District of Columbia and also operates certain commuter rail systems. Amtrak pays freight railroad companies for the use of their tracks.

Railroads in the US are regulated by the Federal Railroad Administration, an agency within the Department of Transportation, as well as state and local authorities. The Federal Railroad Administration has established a program to encourage the development of high-speed rail in the US.

Other infrastructure

Water supply in the US is provided via public water systems managed by state or local authorities. Wastewater treatment facilities are owned and operated primarily by local utilities or public water authorities although there has been some private investment in such facilities. Publicly supplied water is subject to federal standards issued by the federal Environmental Protection Agency.

Many roads and bridges are public assets operated by federal, state and local authorities, including the federal Department of Transportation. However, there are numerous private roads and bridges in the US. Many toll roads have been established via private investment and are operated as for-profit businesses.

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Are there special rules for investing in energy and infrastructure?

Generally

The Committee on Foreign Investment in the United States (CFIUS) reviews the national security implications of transactions that would result in a foreign entity controlling a US business. CFIUS has at times found control when an entity has acquired less than 20% of the

equity of a business. The President is authorized to suspend or prohibit a transaction under CFIUS jurisdiction when the President finds credible evidence that a foreign person controlling a US business might take action that threatens to impair the national security, and when no other provision of law (other than the International Emergency Economic Powers Act) provides suitable alternative authority. CFIUS does not have jurisdiction over greenfield investments or passive equity investments of 10% or less.

Section 7 of the Clayton Antitrust Act of 1914 (Clayton Act) prohibits 'acquisitions of assets or voting securities, the effect of which may be substantially to lessen competition or to tend to create a monopoly.' Enforcement standards applied by the US Department of Justice and the Federal Trade Commission are described in their Horizontal Merger Guidelines. Many transactions are reviewed pursuant to the Hart-Scott-Rodino Amendments to the Clayton Act which require formal advance notification to US Department of Justice and the Federal Trade Commission for many acquisitions of assets or equity interests over a certain size (currently US$80.8 million, a value adjusted annually).

Energy

The Federal Energy Regulatory Commission reviews many mergers and acquisitions involving energy assets pursuant to the Federal Power Act. It is in charge of determining the impact of the proposed transaction on competition and rates and reviewing concerns regarding the concentration of market power. Certain states also require the approval of such transactions by the state public utility commission. Many regulated and private energy companies seek to impose restrictions on the change in ownership or control of energy assets or company or the direct transfer of such assets via contractual limitations placed in long-term power purchase agreements, interconnection agreements as well as construction, supply, warranty and operation and maintenance agreements.

Telecoms infrastructure

As noted above, the Federal Communications Commission is the primary regulator of the telecommunications industry in the US. The transfer of licenses or companies holding licenses is subject to the review of the Federal Communications Commission. Pursuant to the Communications Act, the Federal Communications Commission is charged with determining if the proposed transaction will serve the public interest.

Transport infrastructure

Most investment in the transport infrastructure sector involves the US Department of Transportation (DOT) or an agency within the DOT, in addition to state and local transport authorities. By way of example, investments in roads, bridges and tunnels typically involve the Federal Highway Administration, an agency within the DOT. There are typically a number of legal requirements which must be met by such projects. The Federal Aviation Administration, also within the DOT, oversees the aviation sector. Public transit projects generally fall under the purview of the Federal Transit Administration, also a part of the DOT. Passenger rail and freight rail matters are governed by the Federal Railroad Administration which is once again included within the DOT. The DOT and local port authorities also handle port related matters.

Other infrastructure

In the US, social infrastructure such as schools, housing and hospitals are often operated by state or local authorities although of course many such assets are privately owned and operated. Increasingly, such projects are developed via public-private partnerships. In such cases, the applicable state or local government entity seeking a private investor to partner with will typically establish the relevant requirements in the applicable request for proposals.

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What is the applicable procurement process?

Investing in energy and infrastructure

Generally, project sponsors establish new special-purpose entities to develop individual energy and infrastructure projects. As a result, many energy companies are structured with a parent company, various holding companies and individual projects companies. Investors may acquire an equity interest in specific project companies or in the upstream holding and parent companies. These transactions are typically accomplished via a negotiated purchase agreement. The transaction remains subject to the procurement of necessary regulatory and contractual approvals.

As for the procurement of power and related capacity and ancillary services by regulated utility companies, such companies often conduct requests for proposals (RFP) based on a standard-form agreement. Procurement is based on a procurement plan revised each year and subject to review by the state public utility commission. A public RFP process is managed pursuant to applicable legal requirements and is intended to promote competition and a fair assessment of the available offers. The result is typically a long-term power purchase agreement which forms the economic basis for the development and financing of the applicable generation project. Contracts with retail utility companies are typically subject to approval by the state public utility commission. Retail utilities and industrial customers may also engage in direct bilateral negotiation of such agreements. In recent years, a number of local cooperatives and industrial customers, such as manufacturing facilities, and public customers, such as universities and hospitals, have sought location-specific generation in the form of small generation units, including rooftop solar.

Financing energy and infrastructure

The procurement of financing for energy and other infrastructure projects typically involves negotiation with a bank, financial institution or other lender or investor active in the infrastructure financing market. Often, such an entity is engaged as an arranger to assist with the marketing and syndication of the proposed financing to other players in the market in exchange for the payment of a fee. Many developers and sponsors rely on long-term relationships with such financing parties.

The financing of transport sector infrastructure projects often involves federal Transportation Investment Generating Economic Recovery (TIGER) grants. Rail projects may find funding via Railroad Rehabilitation and Improvement Financing (RRIF) loans. State and/or local governmental agencies also often contribute to the funding of transport projects. These matters are often developed as public-private partnerships (P3). Such P3 infrastructure projects are expanding beyond the traditional transport sector to include schools, housing, hospitals, courthouses, marinas, parking garages and other types of 'social infrastructure.'

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What are the most common forms of funding / investing in energy and infrastructure?

Funding

Financing infrastructure projects in the US can involve different forms of financing:

- traditional loans at the corporate level based on the balance sheet of the parent or holding company;
- project financing which involves loans to or bonds issued by the applicable project company secured by the project assets and equity in the project company – these may include construction and term loans, working capital loans, letter of credit facilities and asset-based securitizations, and the financing may involve a simple project or a portfolio of projects;
- tax equity investments which involve the acquisition by the financing party of an equity interest in order to take advantage of certain tax benefits, such as the production tax credit and the investment tax credit – as above, these financings are used to fund a single project or a portfolio of projects;
- sponsor loans or mezzanine debt;
- municipal bonds (used by state and local governments for public projects) which are typically exempt from federal, state and local taxes – bonds may be supported by fee-based revenues such as those generated by a toll road; and
- federal and state grants, loans or incentives used to fund public and private infrastructure assets – these programs vary by location and asset class (e.g. the federal government has established the Drinking Water State Revolving Fund and the Clean Water State Revolving Fund which offer low-interest loans to local authorities for water supply and wastewater facilities).

Investing

Direct investment in infrastructure often involves the purchase of an equity interest in applicable holding or project companies. In the US, active sponsors and developers often play multiple roles in transactions and an affiliate will act as the contractor, equipment supplier or operator in connection with such an investment. A number of energy companies have created joint ventures to facilitate such transactions.

As noted above, infrastructure projects may also be structured as public-private partnerships.

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Restructuring

Enforcement and sanctions

When can there be regulatory investigations?

Authority to commence an investigation

The following outlines the various circumstances in which regulators have the authority to commence an investigation.

US SECURITIES AND EXCHANGE COMMISSION (SEC)

The SEC can issue subpoenas in connection with any investigation of violations of the Securities Act of 1933 or the Securities Exchange Act of 1934 (SEA).

The SEC conducts investigations in connection with violations of SEC Rule 10b-5, which broadly makes it unlawful for any person to commit fraud in connection with the sale or purchase of any security.

Criminal enforcement of the federal securities laws is done through the US Department of Justice and individual US Attorney's offices throughout the US.

FINANCIAL INDUSTRY REGULATORY AUTHORITY (FINRA)

FINRA may, in connection with an investigation, complaint, examination, or proceeding under the FINRA By-Laws or rules, require testimony under oath or inspect the books and records of any FINRA member or person associated with a FINRA member.

FEDERAL RESERVE

If the Federal Reserve determines that a supervised institution — state member banks, bank holding companies, savings and loan holding companies, non-bank subsidiaries of bank holding companies and of savings and loan holding companies, edge and agreement corporations, branches and agencies of foreign banking organizations operating in the US and their parent banks, officers, directors, employees, and certain other categories of individuals associated with the above banks, companies, and organizations (referred to as 'institution-affiliated parties') —has problems that affect its safety and soundness, or that the institution is not in compliance with applicable laws and regulations, the Federal Reserve may, by law, take action to ensure that the institution undertakes corrective measures.

The Federal Reserve may also pursue informal enforcement action through board resolutions or Memorandums of Understanding.

FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC)

The FDIC pursues formal enforcement actions against FDIC-insured state chartered banks that are not members of the Federal Reserve System, including FDIC-insured branches of foreign banks, officers, directors, employees, controlling shareholders, agents and other institution-affiliated parties associated with such institutions for violations of laws, rules, or regulations, unsafe or unsound banking practices, breaches of fiduciary duty, and violations of final orders, conditions imposed in writing or written agreements.

The FDIC may also pursue informal enforcement action through board resolutions or Memorandums of Understanding.

OFFICE OF FOREIGN ASSETS CONTROL (OFAC)

The Department of Treasury's OFAC may issue subpoenas in connection with any apparent violation of US economic sanctions laws, including the International Emergency Economic Powers Act, the Trading with the Enemy Act, the Foreign Narcotics Kingpin Designation Act, and other statutes administered or enforced by OFAC, as well as related executive orders, regulations, orders, directives, or licenses.

OFFICE OF THE COMPTROLLER OF THE CURRENCY (OCC)

The Department of the Treasury's OCC uses informal and formal enforcement actions to ensure national banks, federal savings associations, federal branches, and agencies of foreign banks comply with the program, recordkeeping, and reporting requirements of the Bank Secrecy Act, its implementing regulations, and related anti-money laundering laws.

FEDERAL TRADE COMMISSION (FTC)

The FTC has authority to subpoena witnesses for testimony and require the production of documents if it has 'reason to believe' the law is being violated through unfair or deceptive acts affecting commerce.

Investigations may be originated upon the request of the President, Congress, governmental agencies, the Attorney General, upon referrals by the courts, upon complaint by members of the public, or by the FTC upon its own initiative.

CONSUMER FINANCIAL PROTECTION BUREAU (CFPB)

The CFPB may issue a 'civil investigative demand' (CID) to any person believed to be in possession, custody, or control of documents or testimony relevant to a violation of federal consumer protection laws.

Standard for commencing an investigation and issuing an administrative subpoena

In general, the standard for commencing an investigation or issuing an administrative subpoena is relatively low. Generally, the standard is met by having a good-faith basis for believing that an investigation may address conduct that falls within the jurisdiction of the relevant regulatory agency. By way of example, the SEC Division of Enforcement's Operating Manual notes that the relevant SEC staff 'should determine whether the known facts show that an enforcement investigation would have the potential to address conduct that violates the federal securities laws. The SEC Division of Enforcement receives information from a variety of sources that may warrant the opening of a new Matter Under Inquiry (MUI), including newspaper articles, complaints from the public, whistleblowers, and referrals from other agencies or self-regulatory organizations (SROs).' The manual emphasizes that these sources are 'suggestions only and should not discourage the opening of an MUI based on partial information.'

It is not uncommon for regulators, and even prosecutors, to commence investigations simply because of allegations of misconduct in press reports.

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What regulatory penalties may apply?

The following is a list of regulatory penalties that may be imposed when a rule breach has occurred.

US Securities and Exchange Commission (SEC)

- Cease-and-desist orders and injunctions
- Civil money penalties for each act or omission that violates any relevant statutory provision or rule
- Disgorgement of fees, compensation or profits
- Rescission of transactions
- Willful violations may be prosecuted as criminal violations, with large fines to entities and potential incarceration for individuals

Financial Industry Regulatory Authority (FINRA)

- Censure, fine, suspension of membership and/or registration, expulsion, cease-and-desist order, or any other fitting sanction

Federal Deposit Insurance Corporation (FDIC) and Federal Reserve

- Cease-and-desist orders
- Restitution or reimbursement
- Indemnification or guaranty to third parties harmed by the wrongful conduct

- Removing institution-affiliated party from the banking institution and prohibiting the party from participating in banking at other financial institutions
- Civil money penalties against institution or institution-affiliated parties

Office of Foreign Assets Control (OFAC)

- Blocking actions against assets within jurisdiction of the US
- Civil money penalties

Office of the Comptroller of the Currency (OCC)

- Cease-and-desist orders
- Civil money penalties
- Prompt Corrective Action Directives (PCADs)
- Safety and Soundness Orders (SASOs)

Federal Trade Commission (FTC)

- Cease-and-desist orders
- Civil money penalties
- Restitution, disgorgement, and other appropriate equitable remedies

Consumer Financial Protection Bureau (CFPB)

- Cease-and-desist orders
- Civil money penalties
- Restitution, disgorgement, refund, rescission, and/or payment of damages

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What criminal penalties may apply?

The regulators may impose criminal penalties in certain cases, including:

- securities or commodities fraud (a fine, imprisonment of not more than 25 years, or both);
- money laundering (violations of 18 US Code section 1956 may involve a fine, imprisonment for not more than 20 years, or both and violations of 18 US Code section 1957 may involve a fine, imprisonment for not more than ten years, or both);
- economic sanctions (a fine, imprisonment of not more than 20 years, or both);
- mail and wire fraud (a fine or up to 20 years of imprisonment, or both and if the violation affects a financial institution, the fine may be up to USD1 million, imprisonment for not more than 30 years, or both);
- conspiracy (a fine, imprisonment for not more than five years, or both if charged under 18 US Code section 371, and a fine, imprisonment for not more than 20 years, or both, if charged with conspiring to commit mail or wire fraud under 18 US Code section 1349); and
- breaches of the Bank Secrecy Act (a fine, imprisonment for not more than five years, or both and willful violations may involve a fine, imprisonment for not more than ten years, or both).

For all of the above-mentioned charges, courts may also impose both forfeiture and restitution orders.

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Tax

Tax issues

Are stamp, registration, transfer or other similar taxes applicable?

Are there stamp, registration, transfer or other similar taxes payable on the advance, transfer or assignment of a loan?

FEDERAL TAXES

No stamp, registration, transfer or other similar taxes are payable on the advance, transfer or assignment of a loan.

STATE AND LOCAL TAXES

Generally, no stamp, registration, transfer or other similar taxes are payable on the advance, transfer or assignment of a loan. However, some jurisdictions (e.g. Florida) impose a documentary stamp tax on loans if the obligation is evidenced by a document (e.g. a note).

Are there stamp, registration, transfer or other similar taxes payable on the taking, transfer or assignment of a mortgage, debenture or other security?

FEDERAL TAXES

No stamp, registration, transfer or other similar taxes are payable on the taking, transfer or assignment of a mortgage, debenture or other security.

STATE AND LOCAL TAXES

Many jurisdictions (including New York and Florida) impose a documentary tax upon the recording of a mortgage. However, when a mortgage is assigned to a new lender without any increase in the amount of the secured indebtedness, the parties may be able to file an affidavit to be exempt from the mortgage recording tax. Likewise, some states will provide a credit for recording tax previously paid in connection with the assigned mortgage.

Are there stamp, registration, transfer or other similar taxes payable on the issue, transfer or assignment of a debt security (e.g. a bond)?

FEDERAL TAXES

No stamp, registration, transfer or other similar taxes are payable on the issue, transfer or assignment of a debt security.

Debt instruments are typically held 'in registered form' because there are sanctions and penalties imposed on both the issuers and holders of bearer bonds. For issuers, these penalties can include the imposition of an excise tax and the denial of interest deductions. For holders, these penalties can include the denial of certain loss deductions or capital gain treatment upon sale, transfer, assignment or other disposition of the debt instrument and the denial of the beneficial portfolio interest exemption from withholding tax on interest payments.

STATE AND LOCAL TAXES

Generally, there are no stamp, registration, transfer or other similar taxes payable on the issue, transfer or assignment of a debt security.

However, some jurisdictions (e.g. Florida) impose a documentary stamp tax on loans if the obligation is evidenced by a document (e.g. a bond).

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Do tax authorities take priority on enforcement?

On the enforcement of security, do tax authorities take priority over secured lenders or secured debt security holders (e.g. secured bond holders)?

FEDERAL TAXES

Although the United States Internal Revenue Service has a super-priority lien that arises upon the assessment of a federal tax even before a notice of tax lien is filed, federal tax liens do not take priority over secured creditors with respect to their collateral.

STATE AND LOCAL TAXES

State taxing authorities do not take priority over secured creditors with respect to their collateral. However, there is an exception for real property taxes, which are liens themselves by statute in each local jurisdiction.

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Is withholding tax on interest payments applicable?

Is there withholding tax on interest payments under a loan?

FEDERAL TAXES

Generally, withholding tax is imposed on payments of interest to persons not resident in the US. However, there are important exceptions often utilized as discussed below.

Interest payments to certain 'foreign financial institutions' or 'non-financial foreign entities' may also be subject to withholding under the Foreign Account Tax Compliance Act if the foreign financial institution fails to enter into an agreement with the IRS which meets certain requirements.

STATE AND LOCAL TAXES

Generally, there is no withholding on interest payments.

However, some states (e.g. California) may impose backup withholding on interest received on loans used in a trade or business conducted in the state unless a proper exemption certificate is provided. For California purposes, dividends, interests, and any financial institutions release of loan funds made in the normal course of business are exempt from backup withholding.

If so:
What is the rate of withholding?

The current rate of US federal tax withholding on interest paid to persons not resident in the US is 30%.

What are the key exemptions?

FEDERAL TAXES

The most commonly relied upon exemptions to ensure that interest paid by US companies to persons not resident in the US can be paid without any US withholding tax include:

- the portfolio interest exemption ((i) a non-US lender (which is unrelated to the US borrower, is not a bank, is not a 'controlled foreign corporation', and is not engaged in the conduct of a US trade or business), (ii) lends money to a US borrower pursuant to a registered debt instrument which pays a fixed rate of interest, and (iii) the non-US lender provides adequate documentation as to its non-US status);
- lending using commercial paper (original issue discount notes with terms of 183 days or less);
- qualification under a US tax treaty for no withholding or reduced withholding; or

- loans by a lender that engages in a trade or business in the US and that will report the interest as income effectively connected with that trade or business. However, any such effectively connected income is subject to US federal income taxation at regular graduated tax rates.

Would the same analysis apply to interest payments under a debt security (e.g. a bond)?

FEDERAL TAXES

The analysis described above is applicable to interest payments under both a loan and other forms of debt instruments; provided it is in registered form (for portfolio interest exemption purposes).

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Are foreign lenders and debt security holders subject to tax on interest payments?

Will the lender be taxed on interest payments under a loan in the jurisdiction of the borrower (other than by way of the application of withholding taxes (if any)), assuming the lender is not otherwise resident in that jurisdiction for tax purposes (e.g. by virtue of incorporation, residence or local branch)?

FEDERAL TAXES

A lender which is not resident in the US, e.g. a corporation, can be subject to income tax in the US at regular graduated tax rates, even without a physical presence, by engaging in a financing trade or business, or using the debt instrument in any other trade or business within the US. To have such a trade or business, US activities must be conducted on a considerable, continuous, and regular basis.

STATE AND LOCAL TAXES

A lender which is not resident in the US, e.g. a corporation, can be subject to income tax in the jurisdiction of the borrower even without a physical presence by engaging in a financing trade or business or otherwise using a note in its trade or business within that jurisdiction, or simply based on receiving a certain threshold of interest from borrowers and other income from within the jurisdiction (so called 'economic nexus').

Would the same analysis apply to interest payments under a debt security (e.g. a bond)?

FEDERAL TAXES

Yes, the analysis described above is applicable to interest payments under both a loan and other forms of debt securities.

STATE AND LOCAL TAXES

Yes, the analysis described above is applicable to interest payments under both a loan and other forms of debt securities.

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Key contacts

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