hedge fund update

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ROPES & GRAY

The following summarizes recent legal developments of note affecting the hedge fund industry:

SEC Proposes New Market Access Rule

As part of a series of initiatives on market structure issues, on January 26, 2010, the Securities Exchange Commission proposed for comment new Rule 15c3-5 under the Security Exchange Act of 1934. Rule 15c3-5 would require all broker-dealers that have direct market access to an exchange or alternative trading system to implement a variety of checks and balances on the use of that access. Affected broker-dealers would be required to implement risk management and supervisory procedures reasonably designed to help prevent erroneous orders, ensure compliance with applicable regulations, and enforce relevant credit and/or capital thresholds. The rule would affect both a broker-dealer's own use of the direct market access and a broker-dealer's ability to provide direct access and sponsored access (including "unfiltered" or "naked" access) to its customers. The broad scope of the rule would apply to trading in all securities on all exchanges and alternative trading systems.

Under current SEC and exchange rules, broker-dealers can provide "direct market access" or "sponsored access" to customers by allowing those customers to access exchanges or alternative trading systems using the broker-dealer's market participant identifier. Trades made by a customer with unfiltered access are not screened by the sponsoring broker-dealer prior to execution. In addition, federal securities laws and self regulatory organization rules applicable to trades executed by broker-dealers are not applicable to trades placed by customers using sponsored access. The SEC notes that as much as 38% of the average daily volume of U.S. equities trading may be comprised of orders placed using unfiltered access.

Proposed Rule 15c3-5 would effectively eliminate a broker-dealer's ability to provide direct or sponsored access to its customers where pre-trade controls are not applied. The rule would require broker-dealers to establish risk management procedures capable of monitoring and managing financial, regulatory, and other risks related to market access, in each case on a pre-trade basis. The risk management controls and supervisory procedures would have to be under the direct and exclusive control of the broker-dealer, and each broker-dealer would be required to regularly evaluate the effectiveness of its controls.

While the proposed rule directly applies only to broker-dealers, the effect on market participants would be significant. For hedge funds and other institutional investors, unfiltered access may facilitate more rapid trading, help preserve the confidentiality of proprietary trading strategies, and reduce trading costs by lowering operational costs, including commissions and exchange fees.

The SEC has asked for public comment and data on a broad range of issues relating to proposed Rule 15c3-5 and market access more generally. All comments must be received by the SEC on or before March 29, 2010.

SEC Imposes First Short-Selling Sanctions Under Amended Rule 105

On January 26, 2010, the SEC sanctioned two investment advisory firms and two individuals for violations of Rule 105 of Regulation M under the Securities Exchange Act of 1934, which prohibits selling short an issuer's securities within a restricted period prior to purchasing the same securities in the issuer's secondary public offering. The settlements in these two separate cases impose the first sanctions by the SEC under amended Rule 105, adopted in 2007. The SEC can be expected to continue its enforcement of Rule 105 and to impose significant penalties for violations.

The amended Rule 105 renders unlawful any short sale made within the shorter of (i) the five business days prior to the pricing of the secondary offering and (ii) the period beginning with the filing of the registration statement with respect to the secondary offering and ending with the pricing of such offering if the short seller then participates in the secondary offering. Rule 105 is designed to protect against market manipulation through short sales that can have the effect of artificially lowering the market price of a security prior to the pricing of its secondary offering, and its prohibitions apply regardless of the short seller's intent in placing the short sale.

In its order against Palmyra Capital Advisors LLC, an SEC-registered investment adviser that managed three hedge funds, the SEC found that Palmyra violated Rule 105 by improperly selling short 50,000 shares of Capital One Financial Corp., at $53.51 per share, within five business days prior to the pricing of Capital One's secondary offering. Palmyra received 50,000 shares in the secondary offering, priced at $49 per share, resulting in a profit of $225,000 for its hedge funds. Palmyra itself, not the hedge funds, was required to disgorge the profit of $225,000, as well as to pay prejudgment interest of nearly $11,000 and a civil monetary penalty of $105,000.

The SEC's second order found that AGB Partners LLC, an investment adviser registered with California and Idaho, and two of its principals violated Rule 105 by engaging in short sales in connection with secondary public offerings. AGB Partners advises one investment fund solely for its principals' account and another that is open to outside investors (the "outside account"). The SEC found that AGB Partners violated Rule 105 in June 2008 by shorting shares of BGC Partners Inc. for the principals' account during the five-day restricted period and then purchasing shares for the outside investors' account in BGC Partners' secondary offering. This transaction, together with an earlier violation of Rule 105, resulted in an unlawful profit of $38,444 for ABG Partners' two investment funds. The SEC sanctions required AGB and the two principals to disgorge (jointly and severally) the $38,444 in profit and pay prejudgment interest of $2,921 and a civil penalty of $20,000.

While Rule 105 does not prohibit selling short securities in one account and purchasing such shares in a secondary offering for another account if the accounts are sufficiently separately managed, the SEC determined that AGB Partners' accounts did not qualify for this exception. Although the principals' account and the outside investors' accounts used different prime brokers and had separate trading strategies, AGB Partners' principals had trading authority over, and shared information regarding trading ideas, investment decisions, and securities positions for both accounts. As a result, the transactions for the separate accounts were aggregated for purposes of applying Rule 105's restrictions on short sales.

CFTC Proposes Speculative Position Limits for Energy Contracts

On January 26, 2010, the Commodity Futures Trading Commission (CFTC) proposed rules to establish speculative position limits on futures and options contracts in four energy commodities which would supplement the position limits and accountability requirements of the exchanges. The proposed rules would set speculative position limits on Henry Hub natural gas, light sweet crude oil (aka West Texas Intermediate or WTI), New York Harbor No. 2 heating oil, and New York Harbor gasoline blendstock. These contracts are currently traded on the New York Mercantile Exchange (NYMEX) and the IntercontinentalExchange (ICE). The proposed rules would establish a new set of position limits on speculative positions for all contract months combined, single month contracts, and spot-month contracts, and would also apply to aggregate positions in the specified energy commodities in futures and options combined.

The basic formulas to be applied to positions in the energy commodities are the same as those currently applied with respect to the limits on positions in agricultural commodities. Specifically, the formula for the all-months-combined limit would be 10% of the first 25,000 contracts of open interest, plus 2.5% of open interest over 25,000 contracts. The spot-month limit in the physical delivery contracts would be 25% of the estimated deliverable supply. However, the proposed energy limits would be automatically reset on an annual basis, rather than only upon a CFTC rulemaking. Moreover, positions would be aggregated across physically-settled and cash-settled contracts, across reporting markets, and at the owner level. Unlike the rules for position limits in agricultural commodities, there is no exception from aggregation for independently controlled positions.

The proposal provides for several exemptions. First, a *bona fide* hedging exemption, similar to the exemption currently applied to positions covered by federal agricultural position limits, would apply to a trader hedging a demonstrated commercial business risk based on its inventory or anticipatory transactions in the physical commodities. Second, the proposal includes a new limited risk management exemption for swap dealers. This exemption would apply to swap dealers establishing positions to offset the positions initiated by their swap customers. While the CFTC and the exchanges currently grant exemptions from position limits to swap dealers on a case-by-case basis through the issuance of staff no-action letters (or similar methods at the exchanges), the proposed rules would make the swap dealer exemptions uniform across all dealers. Swap dealers and *bona fide* hedgers would be required to apply for exemptions and would be subject to routine reporting requirements. The proposed rule would count *bona fide* hedging transactions against a trader's ability to hold speculative positions, so that a trader holding bona fide hedging positions greater than a speculative position limit would not be able to simultaneously hold a speculative position. A swap trader's risk management position also would count against a trader's ability to hold speculative positions. Finally, there is a contemporaneous risk factor exemption for certain delta-neutral positions which would have exceeded the applicable position limit when adjusted by the previous day's risk factors, if such positions would not exceed the limit when positions are calculated using an appropriate contemporaneous risk factor.

Comments on the proposed rules must be received by the CFTC on or before April 26, 2010.

New Quarterly Reporting Requirement for Registered CPOs

A new quarterly reporting requirement for registered commodity pool operators (CPOs) is expected to become effective for the quarter ending March 31, 2010. The new requirement, set forth in National Futures Association (NFA) Compliance Rule 2-46, applies to registered CPOs in respect of each pool for which they have a periodic and annual reporting obligation under Rule 4.22. Accordingly, quarterly reports will be required for pools that have full reporting obligations under CFTC Rule 4.22, and also to pools operated under the more limited reporting obligations of Rules 4.7 and 4.12(b). Quarterly reports will not be required for pools for which a notice of exemption under Rule 4.13 has been filed. The new report must be filed with the NFA electronically within 45 days of each quarter-end. The report must provide the following performance and operational information:

(a) The identity of the pool's administrator, carrying brokers, trading managers, and custodians;

(b) A statement of changes in net asset value for the quarterly reporting period;

(c) Monthly performance for the three months comprising the quarterly reporting period; and

(d) A schedule of investments identifying any investment that exceeds 10% of the pool's net asset value at the end of the quarterly reporting period.

The NFA recently developed a new risk management system designed to assess risks, identify trends, and assign audit priorities. With more timely information, the NFA hopes to be able to fully utilize its risk management system.

White House Green Book Proposals Affect Hedge Funds

The Obama Administration's Revenue Proposals for the Fiscal Year 2011 (the "2011 Green Book") include several items of potential interest to hedge funds. Although the proposals set forth in the 2011 Green Book are intended as recommendations and likely face further debate and consideration, it bears noting that many of the proposals echo items previously included in the Tax Extenders Act of 2009 as passed by the U.S. House of Representatives in December 2009 (the "Extenders Bill"), as well as items proposed in the Obama Administration's first Green Book issued in May 2009. Among the more noteworthy proposals are the following:

(a) *Carried Interest:* Picking up a proposal that was included in both last year's Green Book and the Extenders Bill, the 2011 Green Book includes a proposal to tax as ordinary income all income received with respect to, and gain realized upon the disposition of, certain "services partnership interests" (more commonly known as "carried interests"). Very generally, under the Obama proposal, a "services partnership interest" is an interest in an entity taxable as a partnership for U.S. federal tax purposes held by a person that provides services to the partnership. The various forms of the carried interest legislation proposed in Congress in recent years (including the version most recently proposed in the Extenders Bill) are drafted so as to subject to ordinary income treatment the interests held by most private equity and hedge fund managers and sponsors. The 2011 Green Book proposal would also treat all income received in respect of "services partnership interests" as income subject to self-employment tax. The proposed change in law would be effective for tax years beginning after December 31, 2010.

(b) *Foreign Financial Institution Reporting:* The 2011 Green Book also reiterates the call for comprehensive reform in the area of reporting with respect to offshore accounts and financial assets held directly or indirectly by U.S. taxpayers. These proposals capture the key provisions of the Foreign Account Tax Compliance Act of 2009 (FATCA), previously introduced in Congress in October 2009 and reproduced in the Extenders Bill. Very generally, these proposals call for imposing a new withholding tax on payments of various types of U.S.-source income to foreign financial institutions (FFIs) that fail to comply with new reporting requirements. These reporting requirements would require FFIs to enter into an agreement with the Department of the Treasury and to disclose certain information about accountholders that are U.S. persons (or foreign entities with one or more 10% U.S. owners), including their names, addresses, taxpayer identification numbers, account balances or value and gross receipts and withdrawals or payments from the accounts. Failure to comply would subject payments of various types of U.S.-source income (including gross proceeds from the sale of any property of a type which can produce U.S.-source interest or dividends) to FFIs to the 30% withholding tax, even if the institution has no direct or indirect U.S. account holders. Notably, prior versions of these rules (as set forth in FATCA and the Extenders Bill) were drafted broadly enough to cause most foreign hedge funds, private equity funds and securitization vehicles to qualify as FFIs subject to the enhanced reporting regime. The rules are proposed to be effective for tax years beginning after December 31, 2012.

(c) *Withholding on Equity Swaps and Securities Loans:* Under current law, payments of U.S. source dividends to non-U.S. persons and substitute dividend payments on securities loans, sale-repurchase agreements and substantially similar arrangements are subject to a 30% withholding tax. However, in some cases, foreign hedge funds have been able to avoid withholding on substitute dividend payments using structures developed in reliance on prior IRS guidance. In addition, dividend equivalent payments made to non-U.S. persons under an equity swap that qualifies as a notional principal contract currently avoid withholding by being treated as foreign-source income. In order to conform the treatment of these dividend equivalents and substitute dividend payments with the treatment of U.S. source dividends, the 2011 Green Book proposes to modify the rules to subject to a 30% withholding tax payments on equity swaps to the "extent the income is attributable to (or calculated by reference to) dividends paid by a domestic corporation." In addition, the proposal aims to reform the existing rules applicable to substitute dividend payments in a securities loan or a sale-repurchase transaction. A version of this proposal, included in the Extenders Bill, would have created a grace period that would have exempted payments on certain equity swaps from the 30% withholding tax for two years from the date of enactment. The 2011 Green Book proposal does not include any such grace period and is proposed to be effective for payments made after December 31, 2010.

(d) *End 60/40 Treatment for 1256 Contracts in the Hands of Dealers:* Another item included in the prior Green Book and reiterated in the 2011 Green Book is the repeal of the current rules permitting securities dealers, commodities dealers, commodities derivatives dealers, and dealers in options to treat gain and loss realized on "section 1256 contracts" as 60% long-term and 40% short-term. Accordingly, any gain or loss realized on such "section 1256 contracts" by such dealers would be taxed in full as ordinary income or loss.

(e) *Expiration of Bush Administration Tax Cuts and Additional Rate Changes:* The 2011 Green Book also provides for: (i) the reinstatement of the 39.6% and 36% highest-income tax brackets for U.S. taxpayers (these two top marginal rates had previously been reduced over a number of years by the Bush Administration to 35% and 33%, respectively); (ii) the reinstatement of the limitation on itemized deductions (the so-called "3%/80%" limitation); (iii) the reinstatement of the phaseout of the personal exemption for high-income taxpayers; (iv) a new 20% tax rate for capital gain and dividend income for taxpayers with income over $250,000 (for joint returns) and $200,000 (for individual returns); and (v) a new limitation for taxpayers in the two highest marginal tax brackets that would reduce the tax benefit for itemized deductions to 28%. All such changes are proposed to be effective January 1, 2011.

Other Developments

We recently published the following separate Alerts of interest to the hedge fund industry:

The New Era in SEC Enforcement: Fostering Cooperation

Proposed Legislation Grandfathers Some Tax Benefits for PTPs and Presents Opportunities for Fund Managers Contemplating Going Public as Partnerships

Potential Effects on Funds and Investment Advisers of The Wall Street Reform and Consumer Protection Act of 2009

SEC Adopts Final Amendments to the Custody Rule under the Advisers Act

For further information, please contact the Ropes & Gray attorney who normally advises you.