Ropes & Gray's Hedge Fund Update: April 2010

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

Adviser Registration Changes Move Forward in Senate

Following a meeting that lasted less than 30 minutes on March 23, 2010, the Senate Banking Committee voted to send Chairman Christopher Dodd's 1,336 page regulatory restructuring bill to the Senate floor. The bill contains many of the provisions of a similar bill passed by the House on December 11, 2009. Among other important points, the Dodd bill would, if adopted:

- Require investment advisers with more than $100 million in assets under management to register with the SEC, subject to certain exemptions described below;
- Remove the "fewer than 15 clients" exception under Section 203(b) of the Advisers Act;
- Exempt advisers from the registration requirements with respect to the venture capital funds and private equity funds they advise. The bill would authorize the SEC to define "venture capital fund" and "private equity fund," and to establish special recordkeeping and reporting requirements for private equity fund advisers;
- Exclude from the registration requirement any "Foreign Private Fund Adviser" (defined similarly to the House bill to be a fund that has no place of business in the United States, has fewer than 15 U.S. clients, has less than $25 million in assets under management for U.S. clients, and does not hold itself out to U.S. investors);
- Require registered advisers to keep certain information concerning the private funds they advise available for SEC inspection: (1) assets under management and use of leverage; (2) counterparty credit risk exposure; (3) trading and investment positions; (4) valuation policies and practices of the fund; (5) types of assets held; (6) "most favored nation" agreements; and (7) trading practices (the House bill did not require items 4, 5, or 6); and
- Give the SEC the ability to require the disclosure of the identity of investments or investors for "purposes of assessment of potential systemic risk."

Negotiations in the Senate concerning the Dodd bill are ongoing.

SEC Staff Updates Responses to Questions About the Custody Rule

In light of recent amendments to Rule 206(4)-2 under the Advisers Act, often referred to as the "custody rule," on March 15, 2010, the SEC staff released an update to its responses to questions received by the staff about the custody rule. These responses supersede the previously released responses to questions regarding the 2003 amendments to the custody rule. Although the responses represent the views of the staff and are not a rule, regulation, or statement of the SEC, the responses provide insight into the current views of the staff. For more information on the recently adopted amendments to the custody rule, please see our alert dated January 12, 2010. The text of the amendments may be found at the SEC's website. In addition, the staff's most recent responses to questions about the rule may be found on the SEC's website.

The updated staff responses are divided among the following categories: (1) compliance with respect to the recent amendments to the custody rule, (2) definition of "custody" and the scope of the custody rule, (3) fee deductions, (4) account statements and surprise examinations, (5) notices to clients, (6) pooled investment vehicles, (7) privately offered securities, (8) independent representatives, (9) sub-custodians, (10) auditing of non-pool accounts, (11) balance sheets, and (12) trustees. Responses include the following:

Compliance: In its responses, the SEC staff clarified that a registered investment adviser to a pooled investment vehicle relying on the annual audit provision may satisfy its contractual obligation to obtain an audit of the financial statements of the pooled investment vehicle if the contractual obligation for an audit is evidenced in a partnership agreement, a disclosure statement, or an engagement letter with an auditor.

Definition of Custody: The staff responses note that if a registered investment adviser inadvertently receives securities from a client, the adviser should, within three days of receipt, return the securities to the sender, instead of forwarding such securities to the qualified custodian. If the securities are not returned to the client, the adviser will have custody of the securities. However, the staff further noted that it would not seek enforcement action against an adviser if such adviser inadvertently received, for example, tax refunds from tax authorities, or dividends, and forwarded such client assets within five business days of receipt and maintained appropriate records. The staff also stated that an adviser would not be deemed to have custody of client assets if the adviser solely has the ability to transfer client assets between client accounts maintained at a qualified custodian.

Account Statements: According to the SEC staff responses, account statements may be sent by a qualified custodian to clients electronically; however, a registered investment adviser must form a reasonable belief after due inquiry that its clients are receiving such statements. Among other means, an adviser may satisfy this requirement by being copied on any e-mail notification sent to clients regarding account statement postings.

Pooled Investment Vehicles: The SEC staff responses state that pooled investment vehicles that are organized outside of the United States, or that have a general partner or other manager with a principal place of business outside of the United States, may have their financial statements prepared in accordance with accounting standards other than U.S. GAAP so long as the reports contain information substantially similar to statements prepared in accordance with U.S. GAAP. In addition, any material differences from U.S. GAAP must be reconciled. If an audit does not meet U.S. GAAS requirements, the adviser cannot rely on the "audit provision" under the custody rule.

Privately Offered Securities: Pursuant to the updated staff responses, a registered investment adviser advising a limited partnership that does not undergo an annual audit may satisfy the requirement that a qualified custodian maintain custody of any privately offered securities by keeping the original signed subscription agreement with a qualified custodian. The staff also clarified circumstances in which an adviser may not have custody of privately offered securities under the custody rule. For example, an adviser would not have custody if a client must sign a subscription agreement to purchase privately offered securities, and such adviser has no authority to transfer or redeem such securities without client consent.

AML Guidance on Obtaining Beneficial Ownership Information

On March 5, 2010, the SEC, FinCEN and several U.S. regulatory organizations released joint guidance meant to clarify and consolidate current regulatory expectations with respect to Anti-Money Laundering and Know-Your-Customer (AML/KYC) rules. Generally, and among other obligations, these rules require financial institutions to collect information on the beneficial owners of accounts, shell companies, or other vehicles concealing beneficial ownership with which the financial institutions do business. Unregistered investment companies typically are not subject to AML/KYC rules, and the release does not expand the rules' scope to cover unregistered investment companies. Although the AML/KYC rules generally are not applicable to unregistered investment companies, they can serve as a valuable resource for advisers and administrators designing and maintaining anti-money laundering programs.

The release clarifies that a financial institution's customer due diligence program should be commensurate to the financial institution's size and should include enhanced due diligence procedures for customers that are identified as posing a heightened risk. The release specifically identifies several situations that may present heightened risk: where the financial institution deals with an agent on behalf of an unidentified customer; where the customer is an entity that is not publicly traded in the United States; and where the customer is a trustee. The release also discusses enhanced due diligence procedures that financial institutions should apply to private banking accounts and foreign correspondent accounts. Specifically, information acquired through enhanced customer due diligence should be used when monitoring a client's or an account's activity for discrepancies between the expected activity and the actual activity.

Certain commentators have suggested that the release imposes additional obligations on financial institutions, but the SEC has specifically countered those assertions. It is still unclear how, if at all, the industry will change its AML/KYC policies in response to the release. Given the general uncertainty in the industry regarding the release's impact, if industry practice with respect to AML/KYC does change, it will likely develop over the coming weeks and months.

New ERISA Compensation Disclosure Rules

The Department of Labor is now requiring additional disclosure by employee benefit plans of fees paid directly or indirectly to service providers on revised Form 5500 (Annual Report of Employee Benefit Plan). As a result, employee benefit plans that invest in any investment fund, including private funds, mutual funds, and separate accounts, will be required to disclose certain fees and compensation paid by the funds in which they invest. These disclosure rules apply even if the fund in question is not deemed to hold plan assets (*i.e.*, each class of fund interests is owned less than 25% by benefit plan investors).

Funds that have employee benefit plan investors can expect to receive requests for information from these investors as they attempt to comply with these new disclosure rules. Annual reports for plan years beginning on or after January 1, 2009 are due 210 days after the last day of the plan year.

Some exemptions to the disclosure requirements may be available, including for venture capital operating companies and for certain indirect compensation disclosed by fund managers to the benefit plan. As the new disclosure rules and possible exemptions are detailed and fact-specific, we recommend that fund managers contact the Ropes & Gray attorney with whom they usually work if they have questions regarding these requests for information.

Supreme Court Declines to Hear Appeal of Ruling that Feeder Fund Manager is a Commodity Pool Operator

On March 8, 2010, the U.S. Supreme Court declined to hear an appeal from a Third Circuit Court of Appeals decision that the manager of a feeder fund that did not trade futures directly, but invested in a master fund that did trade futures, was nonetheless a commodity pool operator required to register as such under the Commodity Exchange Act. The manager of the feeder fund argued that because the feeder fund itself was not engaged in trading futures, the feeder fund was not a commodity pool under the Commodity Exchange Act, and accordingly, the manager was not a commodity pool operator. The Third Circuit disagreed, holding that a person need not be actually engaged in the trading of futures contracts to be a commodity pool, but rather need only be engaged in a business in the nature of an investment trust, syndicate, or similar form of enterprise that solicits, accepts, or receives funds for the purpose of futures trading. The Third Circuit found that the purposes of the statute would be thwarted if a fund operator could avoid the regulatory scheme by simply investing in another pool rather than trading. The Supreme Court's decision not to hear the appeal handed a final victory in this case to the Commodity Futures Trading Commission and let stand the Commission's long-standing position on this issue. The case is *Shimer et al. v. Commodity Futures Trading Commission*, Case Number 09-647, in the Supreme Court.

CFTC Allows Funds to Designate Commodity Pool Operator

The Commodity Futures Trading Commission granted no-action relief from commodity pool operator registration to three affiliated managers of commodity pools, where a fourth affiliated firm acts as the designated pool operator for all of the pools and is registered as a commodity pool operator. The structure is intended to facilitate the favorable tax treatment of performance allocations to the three managers. Generally, each general partner or managing member of a pool is required to register as a commodity pool operator (unless an exclusion or exemption is available). The affiliated managers requested the relief to avoid unnecessary duplicative registration burdens. As a basis for the relief, each of the four entities submitted to the Commission a written undertaking agreeing to be jointly and severally liable for the violation by any of them of the Commodity Exchange Act and rules thereunder. Further, the managers represented that all management authority over each of the pools had been delegated to the one registered firm. The no-action letter is CFTC Letter No. 10-03.

New Tax Provisions Affect Hedge Funds

On March 18, 2010, the President signed into law the Hiring Incentives to Restore Employment Act (HIRE Act). The HIRE Act contains several tax provisions that have a material impact on the hedge fund industry. In addition, on March 23, the President signed the Patient Protection and Affordable Care Act and on March 30, the President signed the Health Care and Education Reconciliation Act of 2010 (the Acts together, the Health Care Legislation). The Health Care Legislation contains additional relevant tax provisions.

(a) New Withholding and Reporting Regime

Pursuant to the HIRE Act, beginning in 2013 a 30% U.S. withholding tax will be imposed on a broad category of U.S.-source payments made to a "foreign financial institution" (including most hedge funds formed outside of the United States) unless, in general, such institution enters into an agreement with the IRS to obtain and report annually certain information about its direct and indirect U.S. investors and complies with certain due diligence procedures with respect to its investors. The 30% withholding tax applies to certain U.S.-source payments, such as interest (including original issue discount)—whether or not the interest would qualify as "portfolio interest", dividends, compensation, and certain other payments, including any gross proceeds realized upon the sale or other disposition of any property that can produce U.S.-source interest or dividends, made after December 31, 2012. The HIRE Act provides an exception from certain reporting obligations with respect to certain U.S. investors, including accounts that are held by tax-exempt organizations and individual retirement trusts. Therefore, the primary impact of the reporting requirements is likely to be on any direct or indirect U.S. taxable investors in an offshore fund (although all investors will be effected by the due diligence requirements imposed on the fund). The exact scope of the new requirements and the exceptions remains unclear. The rules are subject to material changes as a result of any future guidance that is expected to be issued by the Treasury.

(b) Imposition of U.S. Withholding Taxes on Certain Dividend Equivalent Payments

The HIRE Act provides that dividend equivalent payments made on or after September 14, 2010 pursuant to a "specified notional principal contract," a securities lending or sale-repurchase transaction (or, as determined by the Treasury, substantially similar payments) that are contingent upon, or determined by reference to, the payment of a U.S.-source dividend will be treated as U.S.-source income and, therefore, subject to a 30% U.S. withholding tax (unless reduced by treaty) when paid to a non-U.S. party. Through March 18, 2012, a specified notional principal contract exists only if it possesses one or more of the following characteristics: (1) any long party to the contract transfers the underlying security to any short party to the contract in connection with entering the contract; (2) any short party to the contract transfers the underlying security to any long party to the contract at the termination of the contract; (3) the underlying security is not readily tradable on an established securities market; (4) any short party to the contract posts the underlying security as collateral with any long party to the contract; or (5) the contract is identified by the Treasury as a specified notional principal contract. After March 18, 2012, the rules will

pick up dividend equivalent payments made pursuant to all notional principal contracts (unless the contract type is exempted by the Treasury).

The withholding tax applies to the gross amount of each dividend-equivalent payment. Accordingly, a 30% withholding tax may be imposed on an amount which, under the terms of the applicable instrument, exceeds the actual net payment made. These new rules may materially alter payment amounts and withholding obligations under existing swap contracts. Thus, a non-U.S. party to an affected swap might receive a payment reduced by the new withholding tax. Alternatively, a U.S. party to an affected swap might be required to "gross-up" for the withheld tax.

(c) **Disclosure of Foreign Accounts**

For taxable years beginning after March 18, 2010, the HIRE Act generally requires U.S. individuals to report their interests in foreign financial assets (broadly defined to include private equity and hedge funds, as well as other foreign investment vehicles, and foreign securities and derivatives with a non-U.S. counterparty) to the extent the aggregate value of such interests is in excess of $50,000. These new reporting requirements are in addition to the Foreign Bank and Financial Accounts Report (FBAR) reporting requirements. Non-compliance and any under-statement of tax liability that is attributable to undisclosed foreign financial assets will result in imposition of penalties.

(d) **PFIC Reporting**

Pursuant to the HIRE Act and Notice 2010-34, each U.S. shareholder of a passive foreign investment company (PFIC) is required to file annually an information statement with respect to its interest in a PFIC with his/her tax returns for taxable years beginning after March 18, 2010. The form of such statement has not yet been disclosed and the Treasury is expected to provide guidance specifying the information to be provided. The prior law required PFIC reporting only if a U.S. person received a distribution from, disposed of an interest in, or made certain elections with respect to a PFIC. Most hedge funds that are formed offshore (and treated as corporations for U.S. federal income tax purposes) are classified as PFICs.

(e) **Additional Taxes Pursuant to Health Care Legislation**

Effective for taxable periods beginning after 2012 the Health Care Legislation imposes a new tax (called the unearned income Medicare contribution tax) of 3.8% on individuals (and similar rules will apply to certain trusts and estates) earning more than a certain "threshold amount," which is modified adjusted gross income greater than $200,000 for taxpayers filing individually ($250,000 if filing jointly or $125,000 if married and filing separately). The 3.8% tax is calculated based on the lesser of (1) net investment income, and (2) the amount that the taxpayer's modified adjusted gross income exceeds the threshold amount. Significantly, (1) the threshold amounts are not indexed for inflation; (2) the tax is subject to the estimated tax provisions; and (3) the new 3.8% tax is not deductible in computing income tax liability.

Effective for *employment* wages received after 2012, the hospital insurance tax on wages has been increased by 0.9% from 1.45% to 2.35% for taxpayers earning more than the relevant threshold amounts described above. Taxpayers will be taxed at a rate of 2.35% on wages in excess of the threshold amount. For example, a taxpayer filing a "single" return with $400,000 in wages would pay 1.45% on the first $200,000 of earnings (a tax of $2,900) and 2.35% on the remaining $200,000 (a tax of $4,700).

Self-employment wages received after 2012 will similarly be taxed at a rate of 2.9%, with a rate of 3.8% on self-employment wages in excess of the relevant threshold amounts (as above, $200,000 if filing "single," or $250,000 for taxpayers filing joint returns or $125,000 for married taxpayers filing individual returns). No deduction is allowed for this 0.9% tax.

(f) Codification of the Economic Substance Doctrine Pursuant to Health Care Legislation

Many of our courts apply an "economic substance" doctrine, under which income tax benefits with respect to a transaction are disallowed if the transaction lacks economic substance. Because the courts applied this judicial doctrine somewhat inconsistently, Congress, in the Health Care Legislation, decided to (1) codify the economic substance doctrine and (2) add a new strict liability penalty for underpayments and understatements attributable to transactions lacking economic substance. A transaction will have economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. The codified doctrine generally applies to transactions entered into after the date of enactment.

Other Developments

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

HIRE Act Reporting Requirements and Foreign Entities

Government Issues Long-Awaited Guidance on FBARs

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