Ropes & Gray's Hedge Fund Update: May–June 2010

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

BaFin Adopts Short Sale Ban for German Financials

On May 18, 2010, the German Federal Financial Supervisory Authority (BaFin) issued three new decrees prohibiting certain short sales. These new prohibitions are in effect from May 19, 2010 until March 31, 2011. First, BaFin prohibited naked short selling transactions in the shares of certain German financial institutions (the German Financials). The ban on naked short selling in the German Financials applies only to the equity of the named institutions and, for example, does not affect the sale of futures, options and swaps, instruments referring to indices or baskets that include the German Financials, or CDS trades with respect to debt issued by the German Financials. (There are also limited exemptions available with respect to trades in the equity securities.) The ban does, however, apply to trades placed anywhere in the world, not just transactions on the German markets. It also covers ADRs and GDRs.

Second, BaFin prohibited naked short selling in debt securities which are admitted to trading on a regulated market in Germany and were issued by an EU member state whose legal currency is the euro (including foreign currency bonds of such countries) (EU Bonds). It is worth noting that this ban applies only to transactions in the individual EU Bonds and not to transactions in indices. BaFin has advised that this ban applies to transactions anywhere in the world, not just trades placed through the German markets. Further, there are exemptions for market makers and certain hedges.

Third, BaFin has banned certain naked credit derivatives transactions if the reference liability includes a liability of an EU member state that has the euro as its currency, or such a member state is the reference entity (or one of several reference entities) of the credit default swap. Credit default swaps purchased to hedge credit risks of an existing credit obligation rather than for speculative purposes are exempt from the prohibition. BaFin has not specified an objective standard for such hedging. This ban applies even where such CDSs are embedded in other instruments, such as credit linked notes or total return swaps. Moreover, the prohibition also includes index and basket products if the index or basket contains at least one liability of an EU country as a reference liability. The ban applies only to transactions concluded in Germany, however, limiting its scope.

Additionally, on June 2, 2010, the German government submitted proposed legislation that would expand the BaFin restrictions noted above in several respects. First, it would expand the ban on equity short sales to cover naked short selling in *all* companies admitted to trading on a regulated market in Germany, irrespective of where the transaction is concluded. However, the ban does not apply to shares of foreign companies unless they are admitted to trading only on the regulated market in Germany. Second, the draft legislation would expand the ban on naked short selling in EU Bonds and EU Bond CDS to also cover debt securities issued by regional and local authorities of EU member states, in addition to debt securities issued by the EU member states themselves (and CDS with respect thereto). Derivative financial instruments which refer to shares or debt securities are not covered by the bans. The proposed legislation also would impose new disclosure restrictions with respect to short sales in any equity security admitted to trading on a regulated market in

Germany (including securities of non-German companies); unlike the current disclosure regime for short sales in the German Financials, these disclosures would reveal the identity of the holder and the volume of its net short selling position. Last, the draft legislation imposes affirmative monitoring obligations on certain institutions and imposes sanctions for reckless or intentional infringement of the proposed rules.

SEC Staff Further Updates Responses to Questions About the Custody Rule

On May 20, 2010, the SEC staff released another update to its responses to questions about Rule 206(4)-2 under the Advisers Act, which is often referred to as the "custody rule." These updated responses are in addition to the SEC staff responses previously released on March 5, 2010, by the staff in light of the recent amendments to the custody rule. Although the updated responses are not a rule, regulation, or statement of the SEC, these responses provide insight into the current views of the staff. The SEC staff's most recent responses to questions about the custody rule may be found on the SEC's website. All modifications or additions to the responses are labeled as "May 20, 2010."

The updated SEC staff responses provided additional information in respect of the following categories: (1) definition of "custody" and scope of the custody rule, (2) fee deductions, and (3) pooled investment vehicles.

Of particular note in the updated responses is Question II.10 under definition of "custody" and scope of the custody rule, which appears to require that collateral posted by an adviser on behalf of a client in connection with a swap agreement be held by a qualified custodian. In light of the significant change in market practice that this interpretation would require, we have contacted the SEC staff to confirm the staff's intention with respect to its response. We anticipate receiving a response from the staff with respect to our inquiry shortly and will provide further details as more information becomes available.

Update on Proposed EU Directive on Alternative Investment Fund Managers

European Commission Directive

On April 30th, 2009, as part of a broad reaction to the global financial crisis, the European Commission published a draft Directive on Alternative Investment Fund Managers (the Commission Directive). The Commission Directive seeks to regulate managers of alternative investment funds who are not currently subject to European regulation but who promote their services in any country in the European Union. Among other regulations, the Commission Directive seeks to require higher capital levels, greater disclosure requirements, and more transparency in the provision of tax information. The Commission Directive applies to any firm that provides management services to pooled investment vehicles that are marketed to investors in the EU with assets under management in excess of €100 million if using leverage. The threshold increases to €500 million for non-leveraged funds. Under the Commission Directive, such investment managers would be required to provide a European financial regulator with extensive disclosures including characteristics of funds managed, identities of investors holding greater than a 10% interest in any fund, and detailed information about any portfolio companies in which a manager's funds hold more than a 30% interest. Managers would also be required to disclose, both to its investors and to a financial regulator, the amount and sources of leverage for each managed fund. Another disclosure requirement requires managers to disclose any side letter agreements to all investors in a given fund. The Commission Directive would also require that managers have a minimum initial capital equal to at least €125,000. Any fund with a value in excess of €250 million would be required to hold additional capital equal to 0.2% of the value exceeding €250 million. Managers would also be required to appoint independent custodians, valuation agents, and risk managers for each pooled investment vehicle. Finally, managers would be required to undertake additional fiduciary responsibilities such as a commitment to treat all investors fairly.

European Parliament and European Council Positions

On May 17th and 18th, both the Economic and Financial Affairs Council (ECOFIN), composed of 27 EU finance ministers, and the Economic and Monetary Affairs Committee of the European Parliament (ECON) responded to the Commission Directive. While endorsing the basic tenets of the Commission Directive, the two bodies passed directives that vary in some significant aspects. Most importantly, the ECOFIN and ECON responses differ on steps that non-EU managers will need to go through to be allowed to market their funds within the EU.

The ECON position prescribes a single EU-wide regulatory regime for non-EU managers. Under the ECON position, managers would be required to obtain a European "passport" by submitting themselves to the authority of an EU regulator and abiding by all EU rules before they could market their funds to European investors. Furthermore, the ECON position would allow a non-EU fund to be marketed into the EU only if the jurisdiction of the fund's incorporation granted the EU reciprocal access to its market. If both the manager and the fund are outside the EU, the manager would need to manage its funds in accordance with the requirements of the Commission Directive and local regulators would be required to act as the European Securities and Markets Authority's agents in enforcing the Commission Directive. While in theory, an EU passport could simplify the marketing of non-EU funds to European investors, it is unclear to what extent the conditions imposed on any such passport would restrict the ability of non-EU managers to market in the EU in practice.

The ECOFIN position, on the other hand, leaves a great deal of discretion to individual members states of the EU. While the ECOFIN position would require a non-EU fund manager to comply with disclosure standards of the Commission Directive, it would leave regulatory power with each individual member state in which the manager is seeking to market its funds.

Proposed Compromise; Timeline

Last week, in an effort to resolve the differences between ECON and ECOFIN, the European Commission proposed a compromise relating to treatment of non-EU managers. The Commission's compromise calls for a three-year transition period during which national governments could maintain control over regulation of non-EU managers and funds. After that, the national rules would be replaced with an EU-wide passport system as proposed by ECON.

It is expected that on July 6, 2010, the three bodies—ECON, ECOFIN, and the Commission—will meet to negotiate and vote on a compromise directive. If substantial differences persist after the July 6th meeting, the parties will be required to schedule further meetings. Assuming the parties reach a final compromise on July 6th, EU countries will be given two years to adopt the law. Using this timeline, a directive could become law by July 2012.

<u>CFTC Position Limits</u>

On May 7, the CFTC staff issued an advisory reminding market participants that they are obligated to comply with speculative position limits on an intraday basis as well as on an end-of-day basis. Speculative position limits apply to positions held on designated contract markets and on exempt commercial markets with significant price discovery contracts. In enforcing speculative position limits, the CFTC and the exchanges rely on information gathered by the CFTC's large trader reporting systems and on equivalent systems maintained by the exchanges. Large trader reports are filed daily at the end of the trading day. However, even though the large trader reports are filed at the end of the day; the advisory clarifies that speculative position limits apply on an intraday basis as well as at an end of the day basis. As a result, a trader whose position exceeds the limits at any time during the day is in violation of CFTC and exchange rules, even if the position is reduced to be within the limits at the close of trading on that day.

SEC Circuit Breaker Approval

On June 10, the SEC approved circuit breaker rules that will require the exchanges and FINRA to halt trading in certain individual stocks experiencing high volatility. The circuit breaker rules will be implemented beginning June 11. The circuit breaker is a pilot program that would pause trading across U.S. equity markets in certain individual stocks in Standard & Poor's 500-stock index for five minutes if the price of the stock moves 10% or more in a five-minute period. The new rules will be in effect through December 10, 2010. This pilot period will be used to make appropriate adjustments to the circuit breakers and to expand the scope to securities beyond the S&P 500. The pilot program follows a drop of nearly 1,000 points in the Dow Jones Industrial Average on May 6. The SEC and CFTC have been studying the causes of this drop and ways to prevent a recurrence.

Carried Interest Update

On May 20, 2010, the House Ways and Means Committee and the Senate Finance Committee released proposed legislation—the American Jobs and Closing Tax Loopholes Act of 2010. The proposed legislation would change the taxation of "carried interests" for hedge funds, private equity funds and certain other managers. Very generally, under the proposed legislation, a percentage of net income (or net loss) allocated to a partner with respect to an "investment services partnership interest" (ISPI) would be treated as ordinary income (or loss), even if it otherwise would have qualified as capital gain. For individuals, the applicable percentage generally would be 75 percent (50 percent for tax years beginning prior to January 1, 2013). For all other taxpayers, 100 percent of such income (or loss) would be characterized as ordinary income (or loss). The legislation was generally proposed to be effective after the date of enactment. (A summary of the proposed legislation may be found in Ropes & Gray May 25, 2010 Tax & Benefits Alert.)

Thereafter, on May 28, 2010, the House of Representatives voted to pass the carried interest legislation. The House-passed version generally follows the draft legislation jointly introduced by leadership in both chambers on May 20, but among other changes, importantly, delays implementation of the new carried interest rules until January 1, 2011.

Most recently, on June 8, 2010, an amended form of the legislation was introduced in the Senate. The amended bill makes several important modifications to the tax provisions that govern taxation of carried interest. Significantly, with respect to individuals, the Senate amendment decreases the amount of ISPI net income (or net loss) recharacterized as ordinary from 75 percent to 65 percent (while retaining the 50 percent two year-year phase-in period). In addition, the amended bill provides that (for taxable years beginning after December 31, 2012) the ordinary percentage is reduced to 55 percent with respect to any net income (or net loss) allocable to gain from the sale or exchange of any asset which has been held for at least 7 years. The amendment retains the effective date of the House bill. The Senate is expected to vote next week on this amended bill.

Other Developments

Ropes & Gray recently published the following separate Alerts of interest to the hedge fund industry:

Preparing for Financial Reform: Derivatives
May 27, 2010

Preparing for Financial Reform: Investment Adviser Registration
May 27, 2010

Preparing for Financial Reform: Investment Companies and Investment Advisers
My 27, 2010

Proposed Legislation Would Increase Tax on Carried Interest, Target Perceived Tax Abuses, and Renew Tax Incentives
May 25, 2010

SEC Proposes Large Trader Reporting System
May 3, 2010

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