Ropes & Gray's Hedge Fund Update: October 2010

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

Summary of Carried Interest Developments and Series LLCs

Jobs Bill Reintroduces Provisions Increasing Tax on Carried Interest. On September 16, 2010, Senator Baucus introduced the "Job Creation and Tax Cuts Act," S. 3793 (the Bill). As with previous versions of this legislation, the Bill contains provisions substantially modifying the taxation of "carried interests" or investment services partnership interests (ISPIs).

For a detailed discussion of a prior bill that passed the House earlier in 2010 (the June Bill), please consult the Ropes & Gray Alert available here. Although the Senate took up the June Bill and proposed certain amendments to it, the June Bill ultimately never progressed through the Senate.

The key aspects of the current Bill include the following:

- As in the June Bill, the Bill provides for a 75 / 50 recharacterization mechanic. In particular, 75 percent of income attributable to an ISPI would be recharacterized as ordinary income. An equal percentage of gain realized on most dispositions of an ISPI would be taxed as ordinary income. The amount treated as ordinary income is, however, reduced to 50 percent in the case of (a) any income that is attributable to the sale of any asset (other than an ISPI) which has been held by certain partnerships for at least 5 years and (b) any gain realized on the disposition of an ISPI held for at least 5 years and attributable to assets held by the investment partnerships for at least 5 years.
- Consistent with the June Bill, income or gain with respect to certain "qualified capital interests" (QCIs) would not be recharacterized as ordinary income. However, ISPIs acquired with the proceeds of a loan obtained from certain affiliates could not qualify as QCIs. The Bill introduces a new provision that may permit partners to unwind such leveraged acquisitions of ISPIs in order that they may qualify as QCIs. Any such restructuring could not be achieved by repayment of the loan with the proceeds of a loan or other advance made by certain affiliates of the partner and such restructuring must be completed before the date of enactment of the Bill.

The Bill would generally be effective as of January 1, 2011. It is currently unclear whether the Bill will be enacted. The results of the November mid-term elections may dictate whether carried interest legislation in any form is enacted in the near future.

Managers of investment partnerships to which these rules may be applicable may want to consider restructurings that may in some cases ameliorate the impact of the new rules (e.g., restructuring in order to separate the holder of any ISPI from affiliated service providers such as management companies and unwinding any leveraged ISPI arrangements).

IRS Proposes Regulations on Domestic Series LLCs. On September 13th, the Internal Revenue Service (IRS) issued proposed regulations clarifying the federal tax treatment of an individual series of a domestic series

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limited liability company (and certain similar entities including domestic cell companies). The proposed regulations generally provide that each series of a domestic series entity, whether or not a juridical entity for state law purposes, is treated for federal income tax purposes as a separate entity formed under local law. Accordingly, the entity classification of such a series will be determined under generally applicable federal entity classification rules, including the "check-the-box" rules. Under the proposed regulations, each series and the umbrella series entity would be required to file a statement with the IRS for each taxable year providing certain identifying information to be specified in the future. The proposed regulations do not apply to series or to cell entities organized or established under the laws of a foreign jurisdiction, except when a foreign series or cell entity engages in an insurance business. Consequently the treatment of such foreign series and cell entities remains uncertain. The proposed regulations indicate that the new rules will generally be effective when finalized. A transition rule permits certain taxpayers to continue to treat a series and the umbrella series entity as one entity provided the series was established prior to September 13, 2010, no owner of the series treats the series as a separate entity, and certain other conditions are met.

IRS Circular 230 Notice

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained herein is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of avoiding U.S. tax penalties.

NFA Know Your Customer Rule Will Change

The National Futures Association's "Know-Your-Customer" Rule (Compliance Rule 2-30) will be expanded, effective January 3, 2011. Rule 2-30 requires NFA members and associates to obtain information about their commodity interest customers who are individuals and provide those customers with appropriate risk disclosure prior to the time that the member directs trading in their account. Rule 2-30 as amended will cover all customers who are not eligible contract participants, not only customers who are individuals. An eligible contract participant, in general, currently includes an entity or an individual that has total assets exceeding $10 million. In addition, the amended Rule prohibits NFA members and their associated persons from making individualized recommendations to customers who have been advised, in accordance with the Rule, that commodity interest trading is too risky for them. This rule change has its origins largely in the CFTC-SEC joint meetings to discuss regulatory harmonization, during which one of the issues discussed related to the similarities and differences between the futures industry's know-your-customer rule and the securities industry's suitability requirements. In light of the differences between the futures industry and the securities industry, however, the character of the current rule, with its premise that the customer is in the best position to determine the suitability of futures trading if the customer receives an understandable disclosure of risks from a futures professional who "knows the customer," has been maintained.

SEC Proposes Rule Defining "Family Office"

On October 12, the SEC proposed a new rule under the Investment Advisers Act of 1940 (Rule 202(a)(11)(G)-1) defining a "family office," as directed by the Dodd-Frank Act. This proposal is the SEC's first published Advisers Act rulemaking proposal under the Dodd-Frank Act. The Dodd-Frank Act amended the Advisers Act, effective July 21, 2011, to exclude family offices, as defined by the SEC, from the definition of an investment adviser. Under the SEC's proposed definition, a family office is a company (including its directors, partners, trustees, and employees acting within the scope of their position or employment) that: has only "family clients," is wholly owned and controlled, directly or indirectly, by family members, and does not

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hold itself out to the public as an investment adviser. A "family client" includes family members, key employees of the family office, charitable entities established and funded exclusively by family members, trusts or estates existing for the sole benefit of family clients, and entities wholly owned or controlled (directly or indirectly) by, and operated for the sole benefit of, family clients.

The proposal includes a grandfathering provision, as required by the Dodd-Frank Act, that includes in the definition of family office any person that was not registered or required to be registered as an investment adviser under the Advisers Act on January 1, 2010 solely because the person provided investment advice, and was engaged before January 1, 2010 in providing investment advice, to certain natural persons and entities associated with a family office. A person that is a family office solely because of the grandfathering provision remains subject to the antifraud provisions of the Advisers Act. Family offices that qualify for the exclusion from the definition of an investment adviser at the federal level would not be subject to registration as investment advisers under state securities laws. Comments on the proposed rule are due on or before November 18, 2010.

Fraudulent Conveyance Clawback: the "Good Faith" Defense

In a much-followed case given the recent publicity surrounding collapsed Ponzi schemes, the U.S. District Court for the Southern District of New York on September 17, 2010 reversed a decision of the Bankruptcy Court from the Southern District of New York that had broadened the scope of those facts and circumstances that may trigger inquiry notice under the "good faith" defense to a fraudulent conveyance claim. In re Bayou Group, LLC, 2010 U.S. Dist. LEXIS 99590 (S.D.N.Y. September 17, 2010).

The U.S. Bankruptcy Code generally provides that fraudulent transfers, such as those to a redeeming investor in a Ponzi scheme scenario, made within two years of the collapse of a fund may be clawed back by the bankruptcy trustee unless the redeeming investor shows that the transfer was received (1) for value and (2) in good faith. An investor who prevails in establishing this affirmative defense may avoid rescission to the extent of its principal investment. While the Bankruptcy Code does not define "good faith," the jurisprudence generally has settled upon a two-prong inquiry: first, whether the transferee was on "inquiry notice," and second, if the transferee was on inquiry notice, whether it satisfied a "diligent investigation" requirement.

The Bayou decisions involve certain of the investors in sham hedge funds managed by Bayou Management, LLC that had redeemed their investments within two years of the funds' 2005 collapse. In the recently overturned decision, the Bankruptcy Court found, as a matter of law, that certain red flags suggested an "infirmity in Bayou or the integrity of its management," and that such red flag evidence was sufficient to trigger inquiry notice among certain of the redeeming investors. The red flags noted by the Bankruptcy Court included (1) notice of a complaint filed against the Bayou funds and the management company by a former Bayou employee alleging, among other claims, the former employee's perception of possible violations of SEC rules and regulations and large withdrawals from the trading account for which no explanation was provided, but which complaint did not include reference to "fraud" or "insolvency"; (2) Bayou's delay in providing NAV calculations, inconsistent statements about who was responsible for preparing the NAVs, and Bayou's ultimate disclosure that it was the management company, and not an offshore administrator, that was calculating the NAVs; and (3) certain unfavorable information regarding the Bayou funds and one of its founders contained in two background reports. Once the Bankruptcy Court determined that these transferees were on inquiry notice, it held they then had a duty to conduct a diligent investigation. The Bankruptcy Court found that, as a matter of law, these redeeming investors failed to conduct a diligent investigation and thus granted summary judgment in favor of the debtors.

In its reversal, the District Court found that the Bankruptcy Court had "significantly expanded" the scope of information that prior courts found sufficient to constitute inquiry notice. Rejecting the "infirmity" standard espoused by the Bankruptcy Court as "so broad as to be undefinable," the District Court opined that such a standard could cover a "host of sins." The District Court instead endorsed a narrower standard, in line with what the District Court characterized as the vast weight of authority, focused on whether the transferee had information that the transferor was insolvent or that the transfer might be made with a fraudulent purpose. Under this standard, the District Court found the issue of whether the investors had been on inquiry notice was a fact-specific question for the jury and not one that could be decided, as a matter of law, by the Court.

While the District Court acknowledged that it is an objective, reasonable person standard that applies to both the inquiry notice and diligent investigation prongs of the good faith defense analysis, it is worth noting that the District Court adopted the less common view that the standard requires a focus on the class or category of the transferee (here, an institutional hedge fund investor) rather than a generic reasonable person.

Because the District Court determined that the question of inquiry notice should proceed to a jury, and thus that summary judgment had been granted inappropriately by the Bankruptcy Court, its discussion of the diligent investigation requirement was brief. The District Court did, however, explicitly reject the Bankruptcy Court's opinion that a so-called "futility argument"—an argument that no diligent investigation could have uncovered the fraud or insolvency—was fatal to the diligent investigation requirement and thus the good faith defense. Since the District Court framed the diligent investigation test as "whether a diligent inquiry would have discovered the insolvency or the fraudulent purpose of transfer," it held that a court would be required to consider whether a diligent investigation would have been futile, and that relevant factual determinations must be resolved by a jury.

EU Hedge Fund Regulation

EU finance ministers have reached a compromise on the EU's first set of rules to directly supervise managers of alternative investments beginning in 2013. There was a significant breakthrough in EU efforts to regulate the hedge fund industry when, on Tuesday, October 19, 2010, after months of negotiations, the UK and France resolved their disagreements over the terms in the AIFM Directive for allowing non-EU-based hedge funds to operate in EU member states (Hedge Fund Update: May–June 2010). The UK position had called for an "EU passport" for non EU-based hedge funds, while the French position had called for national governments to have the power to license hedge funds operating within their territory. The compromise reached allows for the EU-wide passport under strict controls from the new European Securities and Markets Authority (ESMA). As a result of the agreement, the third country regime will be as follows: national private placement regime for two years after implementation, and dual (private placement and passport) regimes throughout the EU until 2018. A review of the new rules will also take place four years after they come into force. The European Parliament still needs to accept the compromise. Should that occur, a final agreement is expected to take place in November.

EU Short Selling Developments

On September 15, 2010, the European Commission published draft legislation for the regulation of short selling of European securities (the Legislation). Intended to harmonize short-selling disclosure requirements across Europe, the Legislation imposes a new two-tier short selling disclosure regime for issuers which have shares admitted to trading on a regulated market within the European Union (and for short positions created by over-the-counter trading and derivatives). Positions that reach, exceed or fall below 0.2% must be privately

disclosed to the national regulators, while positions that reach, exceed or fall below 0.5% must be publicly disclosed. There will be additional notifications required for each change of more than 0.1% above each threshold. To enable national regulators to obtain additional information about short selling volumes, all share orders involving a short sale are to be marked as short by the executing brokers and trading venues are to publish daily summaries of the volume of orders marked as short orders. Additionally, "significant" short positions in sovereign bonds and credit default swaps on sovereign debt issuers are to be privately disclosed to the regulators. It has not yet been determined what will constitute a "significant" short position. The Legislation also would prohibit naked short selling of the shares of any issuer that is admitted to trading on a European market and where the principal venue for trading such shares is in the European Union. Under the Legislation there are limited exemptions to the new regulations available, in particular (i) for shares of issuers admitted to trading on an EU market where the principal venue for trading of such issuer's shares is on a non-EU market, and (ii) for market makers who apply to the Commission for an exemption in their role as a market maker.

National regulators would retain all enforcement powers under the Legislation, including the right to take enforcement action and to request further information. Regulators also will have the power to introduce a circuit breaker whereby they can prohibit for 24 hours the short sale of a share that has suffered a 10% decline in value in a single trading day or otherwise to temporarily prohibit or impose conditions on short selling of shares or bonds of European issuers or the sovereign debt of EU member states.

The Legislation is now at the European Parliament and the Council of Ministers for final negotiation and adoption. If adopted, it will come into effect starting July 1, 2012.

In addition to the Legislation, the proposed European Directive on Alternative Investment Fund Managers (the "AIFM Directive") also contains short-selling provisions which may impose additional disclosure requirements or limitations.

SEC and CFTC Adopt Interim Final Pre-Enactment Unexpired Swap Reporting Rules

Pursuant to Title VII of the Dodd-Frank Act, the SEC and CFTC have adopted interim final rules in respect of the reporting of swap transactions entered into prior to July 21, 2010 and which remained outstanding on such date ("pre-enactment unexpired swaps"). While the SEC's new Rule 13Aa-2T under the Securities Exchange Act of 1934 applies to security-based swaps and the CFTC's new Rule 44.02 under the Commodity Exchange Act applies to all other swap transactions, the rules are substantively identical. References herein to "swaps," "swap data repositories," "swap dealers" and "swap participants" also include "security-based swaps," "security-based swap data repositories," "security-based swap dealers" and "security-based swap participants" when referring to the new SEC rule.

The new SEC and CFTC rules require that a counterparty to a pre-enactment unexpired swap submit (i) a copy of the transaction confirmation in electronic form, if available, or in written form if no electronic copy exists and (ii) the time the transaction was executed, if available. This information must be submitted to a registered swap data repository or to the SEC or CFTC, as applicable, by the earlier of (i) the compliance date that will be established by SEC or CFTC rules, as applicable or (ii) within 60 days after a swap data repository is registered with the SEC or CFTC, as applicable, and becomes operational. The rules also require that the parties to pre-enactment unexpired swaps provide the SEC or CFTC, as applicable, with additional information with respect to such swaps upon request.

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The new rules also specify which party is required to make the required reporting: (i) if one party to a pre-enactment unexpired swap is a swap dealer or major swap participant, that entity must report the swap; (ii) if one party is a swap dealer and the other is a swap participant, the swap dealer must report the swap; and (iii) if neither party is a swap dealer or swap participant, the parties must choose one of them to report the swap.

Finally, the new rules include interpretive notes advising counterparties to pre-enactment unexpired swaps that may be subject to reporting to retain all current information and documents relating to the terms of such swaps, including but not limited to (i) any information necessary to identify and value the transaction; (ii) the date and time of execution of the transaction; (iii) information relevant to the price of the transaction; (iv) whether the transaction was accepted for clearing by any clearing agency or derivatives clearing organization and, if so, the identity thereof; (v) any modification(s) to the terms of the transaction; and (vi) the final confirmation of the transaction. This information may be maintained in its existing format; new records with respect to pre-enactment unexpired swaps need not be created, nor must existing records be modified.

Other Developments

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

SEC Adopts Amendments to Form ADV Part 2 – August 11, 2010

Impact of Financial Reform—Private Fund Investment Adviser Registration – July 21, 2010

Impact of Financial Reform—The Federal Regulation of OTC Derivatives – July 21, 2010

SEC Adopts Advisers Act Rule Addressing Pay to Play Practices – July 9, 2010

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

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