Ropes & Gray's Hedge Fund Update: June 2011

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

Operators of and Advisors to Pools Using Certain Swaps May Need to Consider CPO/CTA Filings

Effective July 16, 2011, certain derivatives provisions of the Dodd-Frank Act will become law, including provisions which expand the definition of a "commodity pool" to include a pooled investment vehicle that trades, or may trade, swaps (other than security-based swaps). Similarly, the definitions of a "commodity pool operator" and "commodity trading advisor" will be expanded to include the general partner (or similar entity) and investment adviser, respectively, of a pooled investment vehicle that trades, or may trade, swaps. Under current law, such definitions only apply with respect to pooled investment vehicles that trade, or may trade, futures. The impact of these changes is that a pooled investment vehicle that invests in any interest rate derivatives, commodity derivatives, derivatives over a broad-based securities index or broad-based credit default index, or most types of currency derivatives, for example, will be a "commodity pool" after this date.

Commodity pool operators and commodity trading advisors must be registered with the Commodity Futures Trading Commission (CFTC) and be members of the National Futures Association (NFA), unless an exemption is available. An exemption from commodity pool operator registration is available to a general partner of a 3(c)(7) fund under CFTC Rule 4.13(a)(4) upon the filing of a notice with the National Futures Association and delivery of prescribed notice to investors. Investment advisors to commodity pools likewise must consider whether an exemption from registration applies or whether they will have to register. An exemption may be available for an investment advisor to a 3(c)(7) fund under CFTC Rule 4.14(a)(8), among other provisions, upon filing of a notice with the NFA. (As described in our previous alert, the CFTC has proposed to rescind the exemptions from registration provided by CFTC Rules 4.13(a)(4) and 4.14(a)(8), but whether and when this will occur has not been determined.)

Many general partners and investment advisers of private funds are already relying on the foregoing exemptions due to their futures trading (or potential futures trading) and have already made the required filings with the NFA. However, some may not have done so, especially if the funds were launched before the 4.13(a)(4) exemption became available in 2003 or if the funds were never intended to invest in futures. Any such entities that operate or advise pools that use (or may use) swaps may want to consider making the required filing with the NFA by July 15 so that they can rely on the exemption. Although CFTC Chairman Gensler recently stated that the CFTC is looking into how to give the market certainty, and may even consider interim relief, the situation warrants close monitoring for compliance with the statutory deadline.

Fund Operators and Advisers Trading Off-Exchange Foreign Currencies May Need to Register as Forex CPOs/CTAs and Comply with Part 5 of the CFTC's Rules

Effective July 16, 2011, the Dodd-Frank Act changes the definition of an "eligible contract participant" (ECP) for pools trading off-exchange foreign currencies to include a look-through provision, so that a pool will not be an ECP unless each investor in the pool is itself an ECP. Generally, to be an ECP, an entity must have total assets exceeding $10 million and an individual must have at least $10 million invested on a discretionary basis. Currently, a commodity pool with at least $5 million in total assets formed by a person regulated by the CFTC is an ECP, and thus can enter into off-exchange foreign currency transactions without restriction.

Once the new definition of an ECP is effective, if a commodity pool trades off-exchange foreign currencies but does not qualify as an ECP under the *Commodity Exchange Act*, its operator and advisers will be subject to the CFTC's Part 5 Rules, which among other things, require the operator and advisor to register with the CFTC as a Forex CPO and a Forex CTA, respectively, and to comply with disclosure, recordkeeping and reporting requirements. In addition, if all of a commodity pool's investors are not ECPs, the pool may only enter into off-exchange foreign currency transactions with certain types of counterparties (U.S. financial institutions, broker-dealers, futures commission merchants, financial holding companies and certain foreign exchange dealers).

Further, the CFTC has proposed that commodity pools be prohibited from qualifying as ECPs under the $10 million test. If this proposal becomes final, a commodity pool, whatever its assets, would fall under the provisions outlined in the preceding paragraph. Many hedge funds could be affected by these provisions.

SEC Chairman States that Advisers of Private Funds are Expected to be Required to Register in Early 2012

On July 21, 2011, Section 403 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* is scheduled to repeal the registration exemption in Section 203(b)(3) of the *Investment Advisers Act of 1940*, upon which hedge fund advisers currently rely.

As noted in our previous alert, in a letter dated April 8, 2011 to the North American Securities Administrators Association, Inc., Associate Director of Investment Management Division Robert Plaze stated that he expected the Securities and Exchange Commission (SEC) to consider extending the registration date by which advisers must register and come into compliance until the first quarter of 2012. He noted that such extension was expected in order to give investment advisers the requisite time to come fully into compliance with the obligations that would arise in connection with registration.

Subsequent to the Plaze letter, Chairman Schapiro reportedly wrote that "I anticipate that the Commission will issue final rules … in advance of the July 21, 2011 one-year anniversary of the passage of the Dodd-Frank Act. However, given the time needed for private equity and other private fund advisers to register and come fully into compliance with the obligations applicable to them once they are registered, I expect that the Commission will consider extending the date by which these advisers must register and come into compliance with the obligations of a registered adviser until the first quarter of 2012."

In a more recent indication that the SEC expects to extend the compliance deadline, Chairman Schapiro testified before Congress on May 12, 2011 regarding the ongoing efforts of the SEC to monitor systemic risk and promote financial stability in the marketplace. With respect to such efforts and in connection with the implementation of Dodd-Frank, Chairman Schapiro acknowledged that advisers of private funds are expected to be required to register with the SEC in early 2012, noting that "Under Title IV of the Dodd-Frank Act, hedge fund advisers and private equity fund advisers will be required to register with the Commission, which is expected to occur in the first quarter of 2012." Although the SEC has not yet officially adopted any extension of the deadline, the letter by Robert Plaze and the statements by Mary Schapiro strongly suggest that the effective date for compliance will be extended.

SEC Proposes New Thresholds for Advisers Act Definition of "Qualified Client"

On May 10, 2011, the SEC issued proposed rules and a notice of its intention to issue an order increasing the thresholds for qualification as a "Qualified Client" under the *Investment Advisers Act of 1940* (the "Advisers Act"), as required by the Dodd-Frank Act. Under Advisers Act Rule 205-3, the Qualified Client standard must be met in order for a client, or an investor in a private fund, to be charged a performance-based fee.

The Advisers Act prohibits an investment adviser from entering into, extending, renewing or performing any investment advisory contract providing for compensation to the adviser based on a share of capital gains on, or capital appreciation of, client funds unless the client meets the "Qualified Client" standard set forth in Rule 205-3. In its current form, Rule 205-3 permits an investment adviser to enter into such performance fee arrangements if (1) the client has least $750,000 under management with the adviser (the "assets-under-management test") or the adviser reasonably believes that the client has a net worth of more than $1.5 million (the "net worth test"), (2) the client is a "Qualified Purchaser" under section 2(a)(51)(A) of the *Investment Company Act of 1940* (the "1940 Act"), or (3) the client is an executive officer, director, trustee, general partner, or knowledgeable employee of the adviser.

As required by Section 418 of the Dodd-Frank Act, the SEC announced its intention to issue an order that will adjust the dollar amount tests in Rule 205-3 to account for the effects of inflation by increasing the assets-under-management test from $750,000 to $1 million and the net worth test from $1.5 million to $2 million. In addition, the SEC proposed the following modifications to Rule 205-3:

- A new provision that will require the SEC to issue orders making future inflation adjustments every five years;
- A revision to the net worth test that excludes the value of a person's primary residence and related mortgage debt that is no greater than the property's current market value from the calculation of a client's net worth; and
- A modification of the Rule's current transition provisions to allow advisers and clients to maintain existing performance fee arrangements that were permissible when the advisory contract was entered into, as well as any such arrangements entered into by an investment adviser at a time when the adviser was exempt from registration with the SEC.

The Dodd-Frank Act requires that the SEC issue an order adjusting the dollar amount tests in Rule 205-3 to account for inflation by July 21, 2011. The SEC is accepting comments on the proposed rules until July 11, 2011.

Managers Should Obtain Information from Investors needed for FINRA Rule Limiting Executives' Access to IPO Shares

The SEC recently approved a proposed rule amendment by the Financial Industry Regulatory Authority, Inc. (FINRA) delaying the effective date of the anti-spinning provisions of Rule 5131 from May 27, 2011 until September 26, 2011. Rule 5131 limits FINRA members' ability to allocate "new issues" to accounts in which directors and officers of such members' past, present and certain prospective investment banking clients have a significant interest, with the objective of prohibiting "spinning" (the practice of broker-dealers allocating built-in gains from "new issue" shares to directors and officers in return for the investment banking business of the companies those directors and officers control). The definition of a "new issue" is the same as in FINRA Rule 5130, and covers most IPOs of equity securities.

Private fund managers that wish to retain the ability to invest in new issues are likely to be required by their brokers to represent that they know the extent to which funds are beneficially owned by Covered Persons (as defined below). Accordingly, fund managers will need to obtain initial affirmative representations, and annual negative consent letters, from investors with regard to their status under the Rule. The recent SEC action provides hedge fund managers and other advisers with additional time to obtain the necessary information from fund investors and other clients.

Specifically, the Rule restricts the allocations of new issues that can be made to the following (each, a "Covered Person"):

1. Directors and officers of (a) companies that file periodic reports under the Exchange Act and (b) companies with any of (i) income of at least $1 million in the latest fiscal year or in two of the last three fiscal years and shareholders' equity of at least $15 million, (ii) shareholders' equity of at least $30 million and a two-year operating history, or (iii) total assets and total revenue of at least $75 million in the latest fiscal year or in two of the last three fiscal years; and

2. Persons receiving more than 25% of their annual income from, or living in the same household with, directors and officers described in (1) above.

The Rule restricts the allocation of new issues to Covered Persons where the allocating broker has received compensation for "investment banking services" from the company with which the Covered Person is associated within the past 12 months or expects to provide such services within the 3 months following the allocation. "Investment banking services" includes, among other things, acting for the issuer in a public or private offering or serving as financial adviser in a merger, acquisition or other reorganization.

A *de minimis* exception under Rule 5131 permits allocations of "new issues" to accounts in which the collective beneficial interest of Covered Persons associated with a particular company is less than 25%. Supplementary FINRA guidance makes clear that accounts in which the beneficial ownership by Covered Persons exceeds 25% may still qualify under this de minimis exception provided they follow "carve-out" procedures designed to limit the exposure of Covered Persons to new issues to less than the 25% threshold. Many fund managers will have such allocation mechanisms in place as a result of their compliance with Rule 5130, which restricts the allocation of new issues to certain financial industry insiders. Such mechanisms should be adapted to meet the requirements imposed by broker-dealers in complying with Rule 5131, and must be disclosed in sufficient detail to investors.

We encourage clients to contact us to so that we may provide a form questionnaire for existing investors, revise fund subscription documents, and update the disclosure related to Rule 5131 compliance in offering memoranda.

Treasury Finalizes TIC Form SLT Reporting Requirements

As part of the system designed by the Department of the Treasury (the "Treasury") to measure portfolio investment into and from the United States, known as the Treasury International Capital ("TIC") reporting system, the Treasury has released final instructions for the reporting requirements of TIC Form SLT ("Form SLT"). Form SLT is a mechanism by which the Treasury can gather information on foreign investor holdings of U.S. securities and U.S. investor holdings of foreign securities, and will require investment advisers to private funds, among others, to file reports with the Treasury regarding such holdings. This information is generally used to track capital flow in international capital markets and to construct and formulate international financial and capital market policy.

In general, Form SLT requires that (i) U.S. resident custodians report long-term U.S. securities held by the custodian on behalf of foreign residents and long-term foreign securities held by the custodian on behalf of U.S. residents, (ii) U.S. resident end investors (such as a U.S.-resident investment adviser) report investments in long-term foreign securities for their own portfolios or for the portfolios of their clients that are not held by U.S. resident custodians and (iii) U.S. resident issuers report long-term U.S. securities held by foreign resident investors, in each case where the consolidated total of all reportable long-term U.S. and foreign securities equals or exceeds the exemption level (currently $1 billion) (the "Exemption Level") on the last business day of the reporting month. A long-term security generally includes a debt or an equity security with either no stated maturity or with an original maturity exceeding one year.

Form SLT reports must be filed by financial and non-financial organizations; managers of private and public pension funds, mutual funds and private investment funds or any other similarly pooled, commingled funds; foundations and endowments; and funds and other similar entities that either own shares or units of, or other equity interests in a foreign related or non-related entity (*e.g.*, a U.S.-based feeder fund owning shares of an offshore-based master fund), or has its shares or units, or other equity interests held by foreign related or non-related entities, that hold foreign long-term securities, or that have issued U.S. long-term securities held by foreign residents, that equal or exceed, in the aggregate, the Exemption Level.

Of particular note to U.S. investment advisers and fund managers is the requirement that such entities must report investments in foreign securities for their own account or for the account of their clients that are not held (and therefore reported) by a U.S.-resident custodian. In addition, to the extent such an investment adviser or fund manager is required to file Form SLT in any month, it will be required to include a report of the covered holdings and issuances of all U.S resident parts of its own organization and of all U.S. resident entities (including funds) that it advises/manages, on a consolidated basis. Reporting obligations under Form SLT are placed on custodians and/or investment advisers of mutual funds, exchange-traded funds, and other pooled, commingled funds, and such funds are not independently obligated to file reports.

Form SLT will go into effect on September 30, 2011. Form SLT is available here and the Instructions to Form SLT are available here.

Summary of Tax Developments

Tax Court Calls into Question Exemption from Self-Employment Tax. A recent Tax Court opinion – *Renkemeyer v. Commissioner*, 136 T.C. No. 7 (2011) – calls into question whether limited partners (including limited partners of hedge fund management companies and of certain general partner entities) should treat their distributive share of the partnership's fee and other income as subject to self-employment tax under Section 1402(a)(13) of the Internal Revenue Code of 1986, as amended (the Code).

Currently, Code Section 1402(a)(13) exempts the distributive share of (as opposed to "guaranteed payments" made to) a "limited partner" from self-employment tax liability. The term "limited partner" is not defined by the statute. In 1997, the Treasury proposed regulations that generally would have prevented certain service partners from being deemed to be "limited partners". Subsequently, Congress imposed a temporary moratorium on those regulations but even after the moratorium expired the Treasury did not attempt to finalize such regulations. Most recently, in 2010, a Congressional proposal attempted to subject business income of service partners and S-Corporation shareholders to self-employment tax but the proposal did not clear the legislative process.

All this confusion notwithstanding, the Tax Court concluded that only partners who are essentially passive investors rather than active service providers should be treated as "limited partners" for purposes of the statute. Although the case involved a state law general partnership with limited liability (an LLP), the logic of the court's decision is, arguably, broadly applicable to all entities treated as partnerships for U.S. federal income tax purposes. Consequently, the decision could affect, for example, an actual limited partner's distributive share of management fee (or incentive fee) income earned through a hedge fund management company (or a general partner entity, if such general partner receives such fees).

The decision does not affect passive income such as capital gains, dividends and interest which are generally not includable in income subject to self-employment tax whether allocable to limited or general partners (and, generally, should not affect incentive allocations – as opposed to incentive fees – composed of such items). Nonetheless, fund managers should remember that, beginning in 2013, the new Code Section 1411, enacted as part of the *Health Care and Education Reconciliation Act of 2010* (P.L. 111-152), imposes a 3.8 percent tax on an individual's annual "net investment income" (subject to certain thresholds). Net investment income generally includes most categories of passive income.

FATCA Update. On April 8, the IRS issued additional guidance (Notice 2011-34) on the application of the provisions of the *Foreign Account Tax Compliance Act* (FATCA). The Notice follows initial guidance from last August (Notice 2010-60) and further describes detailed rules that the IRS envisions should govern FATCA compliance. Among its other complicated rules, the new Notice provides general conditions under which certain investment funds will be deemed compliant with FATCA if, very generally, they are owned solely by (and prohibit investment in them by persons other than) (1) foreign financial institutions that entered into FATCA agreements with the IRS, (2) entities payments to whom would be exempt from FATCA and (3) persons deemed compliant with FATCA. Such conditions include the fund applying with the IRS for (and every three years recertifying) its "deemed compliant" status (and obtaining a special EIN) and making certain other certifications. Treasury and the IRS intend to issue proposed regulations incorporating the advice provided in the Notices as well as a sample FATCA agreement and related FATCA reporting and certification forms.

IRS Securities Partnerships Update. The IRS rumor mill suggests additional upcoming guidance for securities partnerships that use the aggregate method to report the so-called "reverse 704(c)" items (as opposed to asset-by-asset layering). In addition, the IRS also informally indicated that it aims soon to address the more contentious issue of "stuffing" allocations.

Other Developments

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

Potential Extension of Compliance Date for Private Fund Investment Adviser Registration
April 8, 2011

Regulators Propose Minimum Margin Requirements for Uncleared Swaps
April 15, 2011

California FPPC Issues New Interpretive Guidance on Placement Agent Legislation
April 29, 2011

U.S. Treasury Proposal Excludes Certain Foreign Exchange Derivatives from "Swap" Definition
May 2, 2011

The SEC's New Whistleblower Compensation Rules
June 2, 2011

For further information, please contact any of the Partners in the Hedge Funds Group or the Ropes & Gray attorney who normally advises you.