

## YOUR DEFINITIVE HEDGE FUND REGULATION ROUND-UP

### CONVERTIBLE DEBT TRADERS MAY FACE LEVY

CAYMAN VEHICLES MAY BE SUBJECT TO 30% WITHHOLDING TAX

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### UK REVENUE LAUNCHES LLP INVESTIGATION

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### SEC ATTACKS 'INFLAMMATORY RHETORIC' OF ACTIVISTS

CHAIR SAYS SOME SPATS CAN HARM COMPANIES

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### UK FINANCE BILL

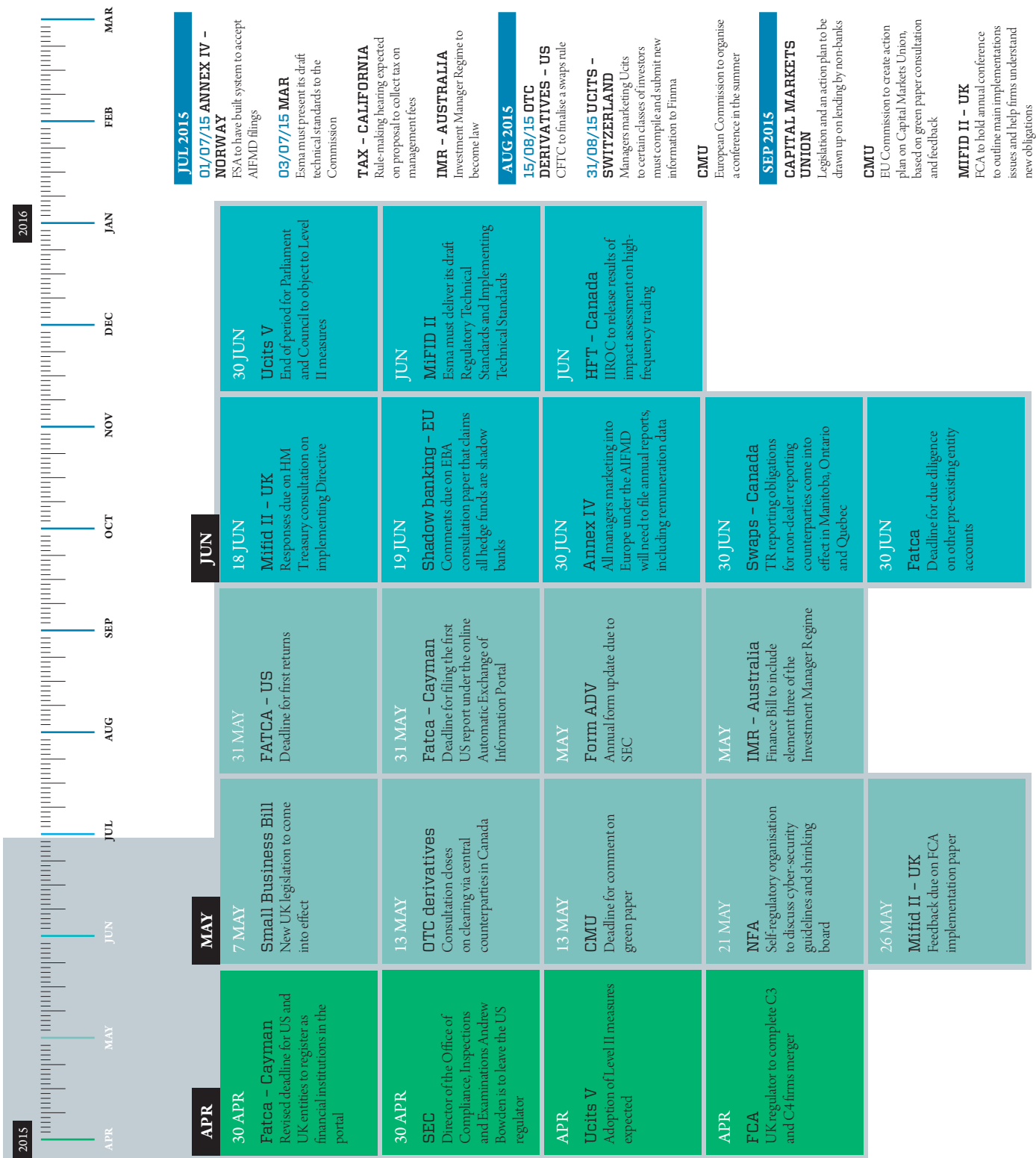
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MAY 2015

# REGULATION INDEX

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CMU

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# CONVERTIBLE DEBT TRADERS MAY FACE LEVY

Non-US hedge funds trading US convertible debt through derivatives could be hit with a withholding tax due to the emergence of a 30-year-old rule that industry experts say they weren't aware of.

Trade body the MFA and industry experts are understood to be quietly lobbying on rule 305(c), which dictates that when a convertible bond experiences an adjustment to its conversion ratio, it creates a 'deemed distribution', triggering a 30% withholding tax on this distribution for the fund in receipt of the bond.

The rules came to light as part of a reference in an upcoming IRS regulation, Section 871(m), which dramatically expands the scope of withholding taxes on dividend payments of swaps and options. Final rules on 871(m) have been continuously delayed, with the latest version set to emerge this month.

Depending on the fund's location, it may be able to reduce the withholding tax if a double tax treaty is available, but Cayman-domiciled funds will not be affording this luxury. Ucits funds may be able to minimise the tax.

It is not yet clear how the levy will be collected as responsibility could rest with the intermediary or the fund. As the rule has been in effect for 30 years, it is unclear how retroactively it will apply.

The IRS has requested more information from industry experts before it reveals further guidance.

AIFMD – UK

# FCA: EXTERNAL VALUERS NOT LIABLE

UK regulator the FCA has revealed that AIFMs are ultimately liable for valuation and that external valuers appointed to provide valuation services cannot be held

accountable in court unless negligence can be proven.

In its quarterly consultation, the FCA said the party making the final determinations on valuing assets – the manager – is considered to be performing the valuation function for a fund.

The FCA report also said AIFMs will have to include short positions and assets with a negative value in valuations.

Managers are liable for valuations and the NAV except where an AIFM can prove that an external valuer acted with negligence as set out in FCA regulations.

The FCA said: "The valuation function involves valuing all the investments in the AIF, including assets with a negative value and short positions."

Indos Financial CEO Bill Prew said: "This seems to say even where an AIFM appoints an external valuer, the manager is still on the hook."

Simmons & Simmons partner Simon Whiteside said: "The FCA has arguably gone too far on requiring an AIFM to be liable for liabilities such as short positions."

TAX – CALIFORNIA

# INVESTORS TO PROMPT NEW TARIFF

Hedge fund firms based anywhere in the world which raise more than \$500,000 in fees from investors in the US state of California are to be hit with a new tax on this income.

Either the management company or the owners of the management company, assuming it is a partnership for US tax purposes, would be subject to the new tax, which is set to be introduced next year but backdated to 1 January 2015.

Assuming a hedge fund manager receives \$25m in allocations from Californian investors with a management fee of 2%, it will trigger the \$500,000 annual fee limit.

The \$500,000 limit will be calculated based on all gross fee income generated from the investors in the state of California. The tax will be paid on net income (gross revenue minus expenses).



# REGULATOR WATCH

By Chris Matthews

The problems encountered by AIFMs completing Annex IV reports were figuratively laid bare this past month as more than 40% of managers missed the initial January deadline.

Sister publication *HFWeek's* FOI request revealed that just 1,013 managers out of the 1,726 authorised, met the 31 January submission date and only a further 273 had filed by the end of February.

The revelation is a damning indictment of the entire reporting process, which was blighted by several issues in the build-up to, and during, online submissions.

Gabriel, the FCA's specially modified Annex IV portal, was hit by lengthy delays and crashes as firms tried to meet the deadline.

The regulator released an update on 12 February saying IT problems were solved, but with almost 500 FCA-authorized firms still not having filed by 28 February, the question is why not?

The amount of other compliance issues firms have to deal with, the lack of clarity surrounding several data points, and the difficulty many non-EU AIFMs have faced in receiving access codes to file, have all affected the filing numbers.

Perhaps the £250 (\$373) 'administration fee' for not filing, and the anti-enforcement rhetoric adopted by the FCA, have had a hand in influencing submission figures.

As with anything new though, there will always be creases to iron out, and I would bet that come the next deadline regulators and managers alike will be a lot better prepared to tackle the Annex IV process head on.



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## DISARRAY REIGNS

BY MAIYA KEIDAN

This month was plagued by disagreements between regulators – the European Banking Authority with the OECD and FSB on shadow banking, the CFTC and European Commission on clearing houses and Germany and Esma on Annex IV.

The EBA launched a consultation on 19 March on minimising the risk posed by institutions being exposed to shadow banks. In it, the regulator claimed all hedge funds should be considered shadow banks and exposure to them should be limited.

The paper says all money market funds, AIFs and unregulated funds are defined as shadow banks, going against what global bodies Iosco and the FSB had determined several months prior after more than a year of investigation. Iosco and the FSB had released a paper last month in which they had determined that only hedge funds with more than \$400bn, including leverage, would qualify for prudential regulations.

The EBA is now saying every institution should set limits on their individual exposure to shadow banks, which should not be more than 25% of overall exposure. The EBA said it would exclude defining entities as shadow banks if they are governed by appropriate alternative prudential rules.

Most recently, German regulator Bafin seemed to call into question Esma's readiness to accept Annex IV reports. Bafin had prepared itself to accept AIFMD filings from 16 March but pushed the deadline back to mid-May, blaming Esma's central database.

"Technically, Bafin could activate the production system on 16 March," said a Bafin spokesman. "However, Esma has indicated that their production system will not be available before 20 May. Resulting from the revised Esma schedule, Bafin has decided to postpone the activation of the production system until mid-May in order to avoid the interim storage of unprocessed data."

For its part, Esma says its central production system is not related to national Annex IV reporting deadlines.

Meanwhile, the argument between the CFTC and the European Commission on clearing houses advanced as CFTC chair Timothy Massad shifted from publicly criticising continental regulators for their stance to promising authorities had returned to the negotiating table.

As an example, if the net income of the management company is \$1m and included in the gross income is more than \$500,000 in fees from CA-based investors the company is subject to the tax filing. The next step is to figure out how much net income is subject to tax. If 10% of the gross income is from CA investors then \$100,000 of the \$1m would be subject to taxation. If the management company is owned 50/50 by two individuals each owner would have \$50,000 of CA income they would need to pay 13% income tax on.

Management company owners may be able to write some of the tax down as they will be able to get a tax credit in their resident state for the tax paid to California. For managers outside the US, tax treaties deal with federal law and not state law. Some jurisdictions may be able to access a tax credit against some of the charge.

### SOUTH AFRICA

## REGULATORS OVERHAUL REGIME

South African hedge funds faced tougher regulation from 1 April as the country overhauled its treatment of the sector.

Hedge funds are now defined as collective investment schemes that use any strategy or take any position that could result in the portfolio incurring losses greater than its aggregate market value at any point in time, with strategies including leverage and net short positions.

Pre-existing hedge funds must submit an application with the Registrar of Collective Investments (RCI) within six months of 1 April and must fully comply with the new rules within one year.

Although hedge funds in South Africa have been subject to registration under the Financial Advisory and Intermediary Services Act since 2007, market participants have acknowledged the industry is generally viewed as unregulated and the legislation would be a positive marketing tool.

Hedge funds will need to report a full list of gross and net assets to the RCI as well as all positions in the portfolio and risk management measures relating

to market, liquidity, counterparty and derivatives risks.

New rules will also require all hedge funds to have independent directors or trustees to beef up governance standards.

### TAX – UK

## REVENUE LAUNCHES LLP INVESTIGATION

The UK Revenue has embarked on a national campaign to examine how firms have restructured their partners and salaried members within a Limited Liability Partnership (LLP), *HFMCompliance* understands.

The move follows the introduction of new tests to prove the validity of partner roles introduced by the government last April. HMRC has sent letters to various firms in March to investigate how they have reacted to the new regime.

"There are some LLPs that have received enquiries from HMRC over restructuring undertaken as a result of the salaried members' legislation," said Debbie Anthony, head of hedge funds at Deloitte.

"I am not aware of any hedge funds that have been questioned yet, but I expect there will be. We fully envisage hedge funds will be asked."

One tax partner told *HFMCompliance* that an HMRC inspector had informed them that hedge funds would be examined as part of this campaign.

A spokesman at the Revenue said: "HMRC has been conducting enquiries to ensure firms are correctly applying the salaried members and mixed membership legislation in the Finance Act 2014."

Partners must 'fail' one of three tests in order to prove they are partners. These are showing significant influence, variable remuneration or profit allocation of more than 25% of non-variable salary.

Anthony advises hedge fund managers that opted to prove significant influence in order to justify partnership status – the vast majority – to ensure their documentary records of management committee meetings support the position taken as this evidence may be examined by HMRC.

Mark Waddilove, partner at Baker Tilly, said: "There will be a focus on hedge funds because HMRC knows exactly how they are structured."

## ENFORCEMENT – US

# SEC ATTACKS "INFLAMMATORY RHETORIC"

Activist shareholders and companies should reduce public spats and more constructively engage, SEC chair Mary Jo White said at an event on 19 March.

"I do think it is time to step away from gamesmanship and inflammatory rhetoric that can harm companies and shareholders alike," White told the Annual Corporate Law Institute in New Orleans, Louisiana.

"Even though the SEC staff does not act as a 'merits or behaviour referee', parties should still take a hard look at their actions and rhetoric."

But activist managers say airing grievances publicly, often through media, is important to their strategy.

One CIO at a \$450m New York activist said: "It is very easy to say that one should have these discussions with boards behind the scenes, but, in many instances, it is that bringing of issues into the public light that is what effectively places pressure on board and management teams to engage."

While White notes the SEC's role is not to determine whether activist campaigns

are beneficial, she says it must ensure shareholders are provided with adequate disclosure and all parties abide by the rules.

Dechert partner Peter Astleford said: "How hedge funds go about this business is not directly a matter for the SEC. On the other hand no manager wants the SEC to pay them a special visit so it is an interesting tightrope."

## INSIDER TRADING – US

# CONGRESS SEEKS TO TOUGHEN LAW

A Connecticut Congressman has introduced bipartisan legislation in an attempt to create a statutory definition of insider trading for the first time and address "ambiguous" case law.

The move follows a landmark ruling in December when Todd Newman, former portfolio manager at Diamondback Capital, and Anthony Chiasson, trader at Level Global Investors, saw their insider trading convictions overturned by a New York appeal court.

The court ruled that it must be proven the person passing on the information, the tipper, receives a benefit and the person receiving the information, the tippee, knew about it for an insider trading conviction to be brought to court.

Lawyers say the ruling significantly narrowed the powers of prosecutors or

the SEC to bring insider trading cases. Other hedge fund traders convicted of insider trading are now appealing their convictions on the back of the case.

The Insider Trading Prohibition Bill is being introduced by Democratic Congressman Jim Hines from Connecticut and co-sponsored by Republican Steve Womack and Democrats Carolyn Maloney and Emanuel Cleaver.

The Bill makes it a federal crime for a person to trade on non-public information when the information was wrongfully obtained, or when the use of information would be deemed wrongful.

It would also be unlawful for a person who wrongfully obtains non-public information to communicate that tip to another person when it is reasonably foreseeable that the person is likely to trade on that information.

These rules would have changed the New York court decision requiring the tipper to receive a benefit as long as the tippee was aware, or recklessly disregarded, that the information was wrongfully obtained or communicated.

The bill defines "wrongful" as information that has been obtained through "theft, bribery, misrepresentation or espionage, a violation of any federal law protecting computer data or the intellectual property or privacy of computer users, conversion, misappropriation or other unauthorised and deceptive taking of such information, or a breach of any fiduciary duty or any other personal or other relationship of trust and confidence."



**SECRET  
COO**  
→

The COO at a \$1bn-plus UK manager says it's time to stop looking for scapegoats and create uniform, simplified rules

### What is the biggest compliance challenge your firm currently faces?

The volume of compliance (and tax) regulations and reporting requirements from any jurisdiction that we trade in or have clients resident in.

If you were put in charge of the FCA for a day, what

### would be the first thing you'd change?

The attitude. The financial crises was seven years ago and, while it is taking a long time to get over it, stop looking for scapegoats and judging people with 20:20 hindsight. Now is the time to move forward to create a logical and workable set of rules that works with and for the financial services industry to keep London a world leader in this field. Unfortunately this cannot be achieved in a day so I

would suggest Boris Johnson for chairman as he has the charisma, authority and Rolodex to begin the process!

### What do you think should be the primary focus of global regulators right now?

Create a uniform set of simplified and workable rules and reporting requirements. There is no reason to have different rules in different jurisdictions other than for the political aims of politicians.

### If you could scrap any piece of legislation and start again, what would it be? Why?

AIFMD because it increases reporting requirements without better protecting investors.

### What advice would you give to someone entering hedge fund compliance?

Go for it. In the current climate, there is plenty for you to do and learn. Once you have mastered your brief, set about trying to influence change.



## CASE STUDY

### INSIDER TRADING

BY DAVID MILLER,  
PARTNER AT MORGAN, LEWIS & BOCKIUS

**Q. What best practices can hedge fund firms implement now to stay ahead of any investigation?**

**A.** Over the past decade, regulators have been focused on the hedge fund industry's trading practices. Government authorities, most notably the US Attorney's Office for the Southern District of New York and the SEC, have brought several high-profile insider trading actions against individuals, which have had significant monetary and reputational repercussions for their funds and the industry. Given these high stakes, we suggest that funds and their managers adhere to the practices below to avoid or address potential enforcement actions for alleged insider trading.

First, hedge fund managers must have a robust compliance programme. Such a programme should include a sufficient number of trained compliance professionals (with clear lines of responsibility), strong written compliance policies, and a management team that leads with a culture of compliance. Legal or compliance officers must conduct regular training that is aimed to inform and provide concrete guidance. Training materials should be posted on shared drives and periodic reminders should be sent to personnel. Also, there should be regular testing and audits of the fund's compliance systems.

Second, it is critical that managers regularly monitor their trading systems and mandate strict use of restricted lists. To this end, managers need to conduct surveillance of their trading activity; periodically monitor emails, telephone calls and instant messages; pre-clear trading from personal investment accounts; use restricted lists for companies about which the fund may have material non-public information; limit and establish clear rules for the use of expert networking firms and industry experts; and monitor the fund's interactions with those affiliated with public companies.

Third, if a government investigation is commenced, there are several steps managers can take to mitigate the investigation's disruptive effect. Fund counsel should institute a 'litigation hold', investigate early and proactively frame the facts for enforcement authorities. Depending on the circumstances, fulsome presentations to the regulators on what transpired and why the fund should not be held responsible may be advisable. At the same time, counsel may attempt to negotiate the scope of any burdensome grand jury or commission subpoena.

While there are several best practices to avoid or stay ahead of a government investigation, the above are critical first steps in mitigating the disruptive effects of an insider trading inquiry.

It also authorises the SEC to exempt any person or transaction from liability under this bill at its discretion.

### AIFMD – GERMANY

## BAFIN DELAYS ANNEX IV DEADLINE

The German regulator has delayed the deadline for submitting Annex IV reporting requirements by two months, blaming Esma's central database.

German AIFMs were due to report on 16 March, but it has now been delayed until mid-May and only a test system will remain in its place.

The Federal Financial Supervisory Authority (Bafin) has already delayed its test by one month after being hit by its own technical issues.

The regulator blames new delays on Esma's central data collection system.

All national regulators within the EU must collect data and then submit it to Esma in a central database where it can analyse the European AIFM market.

A Bafin spokesman said: "Esma has indicated that their production system will not be available before 20 May. Resulting from the revised Esma-schedule, Bafin

has decided to postpone the activation of the production system until mid-May in order to avoid the interim storage of unprocessed data."

Esma says its central production system is not related to national Annex IV reporting deadlines.

Bafin has 480 AIFMs reporting into its MPV system. Preqin data shows there are 33 hedge fund firms in Germany with 73 funds and \$8.6bn in AuM.

### CYBER-SECURITY

## SEC BUDGET JUMPS 40%

The amount of money spent by the SEC on its cyber-security policies has increased by 40% in the last year, an FOI request has revealed.

In 2014 the US regulator allocated \$16.38m to its cyber-security programme, an increase of 40% on the \$11.7m spent during the previous 12 months.

The spike in expenditure reflects the regulator's growing focus on issues of cyber-security in recent months.

The same FOI request made by *HFMWeek* to UK regulator the FCA was rejected as it could leave them "vulnerable to attack if unscrupulous individuals considered we were not sufficiently protected".



## PEOPLE MOVES

HFM COMPLIANCE ROUNDS UP THE SECTOR'S LATEST LEGAL AND COMPLIANCE MOVES

Energy and commodities specialist **CF Partners** has hired **J Safra Asset Management COO Raj Patel**. Patel has been brought on board to head up operations and help grow the firm's asset management business.

London alternative lending specialist **Venn Partners** has hired former CQS head of operations **Luke**

**Venables** as COO/CFO. He joined the roughly \$1.5bn manager in February to replace **Peter Bowden**, who left the firm at the end of March.

**JP Morgan Alternative Asset Management** (JPMAAM) head of operations and ODD **Michael Garvey** is set to leave next month. Garvey, who is also a managing

director, has spent over 14 years at the investment bank, joining in 2000 as a vice president before heading up ODD and operations in 2001.

**Duff & Phelps** has promoted **Ryan McNelley** to managing director. He specialises in the valuation of illiquid securities and interests and has clients in both the US and Europe.



## NEWS IN BRIEF

### NEW REGIME

Australia has unveiled the long-awaited third and final tranche of its Investment Manager Regime, which aims to attract foreign investment and promote the use of local fund managers.

The draft legislation is designed to remove tax impediments to foreign investments into or through Australia by foreign managed funds but previous iterations have been extensively criticised for adding new barriers.

### TAX RULINGS

A possibility that tax rulings in European member states could be made public is “problematic” for hedge fund managers who might have been the subject of rulings over the last 10 years, industry experts say.

The European Commission proposed publicly disclosing all tax rulings in its package of tax transparency measures unveiled on 18 March, although industry experts hope to persuade policymakers to go no further than current obligations.

### TRADING BAN

Hedge fund manager Daniel Shak has been fined \$100,000 for violating a two-year CFTC ban on trading certain futures contracts.

The civil penalty settles charges he traded two gold contracts during the closing period on 22 May last year in breach of an earlier ban for attempted manipulation of crude oil futures.

### LANGUAGE DEBATE

National regulators should allow hedge fund managers to report certain information in English in Annex IV reports in order to aid multinationals, Esma has said.

Esma said in its latest Q&A published on 26 March that AIFMs should be able to report assumptions and stress tests in English, which will allow multinational groups to centralise and harmonise AIFMD reporting.

Liquidated hedge funds should submit

the last AIF report no later than one month after the quarter in which it was liquidated.

### SHADOW BANKING

All hedge funds should be considered shadow banks and exposure to them should be limited, according to a controversial new consultation by the European Banking Authority.

The EU regulator said all AIFs and unregulated funds are defined as shadow banks, despite global bodies Iosco and the FSB saying that only hedge funds with more than \$400bn, including leverage, would qualify for prudential regulations.

### DARK POOLS

The FCA will investigate conflicts of interest in dark pool trading with a thematic review in the first quarter of 2016.

In its business plan for 2015/16, published on 24 March, the UK regulator said it will also launch a post-authorisation review of asset manager funds in 2016 lasting 12 months.

The agency said the dark pool investigation is the next step in its review into wholesale markets practices, which has focused on benchmarks in the last 12 months after foreign exchange and Libor rigging scandals.

### FATCA

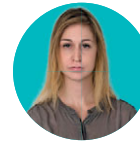
The Cayman Islands has launched its Automatic Exchange of Information (AEOI) Portal for registering and submitting reports to comply with US anti-tax evasion regulation Fatca.

The Tax Information Authority (TIA) opened the portal on 23 March, extending the deadline for US and UK financial institutions to register from 31 March to 30 April.

### DATA HUB

Hedge fund managers and other market participants that trade OTC derivatives and report under Mifid will see their information collected and centralised by Esma.

The Mifid project will go live in early 2017 while the Emir one will be ready in 2016.



## TAX CENTRE STAGE

BY MAYA KEIDAN, *HFMWEEK*

Tax certainly usurped many other regulatory dossiers this past month – particularly in the UK as predictable anti-tax evasion rhetoric ramped up ahead of the election.

In this month's issue, Kinetic Partners managing director of tax Stephen Rabel deciphers the UK Finance Act and the anti-avoidance legislation meant for private equity funds that will sweep hedge funds into the net.

It also emerged over the past four weeks that non-US hedge funds trading US convertible debt through derivatives could be hit with a withholding tax due to the emergence of a 30-year-old rule that industry experts say they weren't aware of.

Trade body the MFA and industry experts are understood to be quietly lobbying on rule 305(c), which dictates that when a convertible bond experiences an adjustment to its conversion ratio, it creates a ‘deemed distribution’, triggering a 30% withholding tax on this distribution for the fund in receipt of the bond.

The Fatca implementation drive continued as Luxembourg published its draft law and intergovernmental agreement on 27 March – several months following other countries – and the Cayman Islands launched its portal for registering and submitting reports on 23 March. The regulator extended the deadline for US and UK financial institutions to register from 31 March to 30 April.

And if current tax rules weren't enough to contend with, the European Commission has also proposed a new set of changes that could be “problematic” for hedge funds. It is being proposed that tax rulings in member states be made public, meaning managers who might have been the subject of rulings over the last 10 years would see this information readily available.

“Issues would be potential public backlash and confidentiality/data protection,” Mark Stapleton, partner at Dechert has said in response.

Also this month, it was revealed that the UK tax authority has launched an investigation into limited liability partnerships (LLPs). Investigators from the Revenue have reportedly sent letters to asset managers asking to examine how they have introduced new tests to prove the validity of partner roles introduced by the government last April.

And industry experts say it's only a matter of time before the Revenue turns its gaze to hedge funds, so the industry needs to be ready with well-documented minutes and other evidence.

The bad news is that the industry is only set to see more tax changes coming down the pipe, with the Base Erosion and Profit Shifting (Beps) and UK version of Fatca still to be ironed out.



# HOW TO NEGOTIATE A PB AGREEMENT

As upcoming obligations put stress on prime broker relationships, *HFMCompliance* explores how to navigate documentation

BY JASMIN LEITNER

**T**he introduction of the AIFMD and Dodd Frank, as well as upcoming obligations under Emir and Basel III, have led to numerous well-documented changes to the way hedge funds run their businesses. But the new regulations are also hitting their service provider relationships.

Aside from needing to update their documentation to reflect regulatory changes, balance sheet pressures on prime brokers means that the negotiation of commercial and legal terms has become tougher, particularly for smaller managers and start-ups.

*HFMCompliance* examines some of these changes, and asks regulatory experts what managers should bear in mind when selecting their prime brokers, and negotiating – or re-negotiating – the relevant agreements.

## Upfront considerations

As well as determining the services required from a prime broker and the skill sets or specialisms of various entities, a number of other factors should affect a manager's choice of provider, such as seeding arrangements and whether they are in the scope of Emir or Dodd-Frank.

Dechert partner Abigail Bell says determining the regu-

latory regime – or regimes – that will affect a hedge fund's derivative trading activities early on is key as this will affect how a fund trades, who it trades with and how those trades are documented.

Similarly with Emir, managers need to determine whether they will take on various functions themselves on behalf of the fund, such as reporting or portfolio reconciliation, or if it will be more effective for these functions to be delegated to the fund's dealer or, in some cases, a third party.

This will also filter into commercial discussions between a prime broker and the hedge fund as there may be a cost for delegating the reporting requirement. Bell says: "To the extent that trades need to be cleared, there will be substantially different margining terms and costs."

The requirement under the AIFMD for an AIFM to appoint a depository for an EU AIF or a non-EU AIF, which is to be marketed into the EEA, has also complicated matters, particularly around liability, sub-custody arrangements and segregation of assets.

Other than in limited circumstances, a depository for an EU AIF will be subject to strict liability for the loss of any financial instruments held on behalf of the fund, including assets held within the sub-custody network, although it may contract out of that liability if certain conditions are met.



As a consequence, upon the establishment of a new depository/prime relationship, there will need to be discussion as to the appropriate allotment of responsibility between service providers.

“The depository’s key concern will be that it is effectively being asked to underwrite the prime broker’s sub-custody network,” Bell points out.

While managers will not necessarily be party to the negotiations between their depository and prime broker, Bell highlights that they need to be aware of these issues and their impact on fees and timing when selecting service providers.

“Managers should enquire of their service providers as to whether a template form has been agreed between their depository and PB and if not, significant time should be added to the PB account opening times for AIFs,” Tom Mortlock, solicitor, derivatives and trading at Macfarlanes, adds.

The strategy of the fund, and where they plan to trade, could also raise some issues if neither the depository nor the prime broker want to underwrite a sub-custodian in a particular jurisdiction.

“Negotiations with depositories are becoming more frequent,” the head of sales and marketing at one London-based PB says, adding this is especially the case when neither party is willing to hold cash assets in some emerging or frontier markets where there are legal and structural uncertainties.

Bell explains managers will need to request a breakdown of a prime broker’s sub-custody network per country to drill down on the identity of the sub-custodians being used and ensure they will be permitted to hold assets in each country in which they intend to trade.

### Considerations during negotiations

Managers, and the legal experts they employ to assist with fund setup and negotiations, very much characterise the documentation as being in favour of prime brokers, although they argue it shouldn’t prevent managers from trying to achieve more equitable terms.

“From the prime broker’s perspective, unless the manager is in the billion-dollar club, the reality is that the bargaining position is going to be in their favour; they know they don’t have to accommodate the fund because the fund needs them, and not necessarily the other way round,” says Kate Wormald, founder of legal advisory firm Oesa Partners.

She adds that strategy and the associated level of risk will always factor into proposed terms. “[Prime brokers] are the ones facing the street and putting on the trades, so their risk levels [are impacted].”

Managers need to be realistic about what they can achieve, and understand how they are viewed by their counterparties, she says. “The cost and risk of financing different strategies and products varies, so a Ucits fund is more transparent and far less risky [to service] than an [illiquid] credit fund, for example.”

Alastair Cameron, European head of client servicing and on-boarding for Nomura’s prime finance group, agrees.

“The variety of funds we face is significant, depending on factors such as size, trading strategy and how they’re run as businesses.”

A senior figure focused on client servicing within another PB admits that once they are familiar with a client and their offering, they are more likely to be comfortable with pieces of a business that are “riskier” but that “the documentation initially has to be weighted to the lowest common denominator [across all funds]”.

Although commercial and legal negotiations often take place separately, many points covered are linked, and Wormald says managers need to bear this in mind.

“How much of the assets a prime broker can use directly affects the financing rate they can offer – it never ceases to amaze me that people don’t realise the financing and margin terms offered are directly referable to the rehypothecation rate; the two offset each other,” she says.

“The economics of our business do rely on some of those elements [such as rehypothecation and client money] and the manager’s openness to some of those points will have an impact on the commercial proposition,” the London-based PB sales and marketing head says. “There’s only one way we can go with certain managers.”

“If you came to a PB with a certain book of business and said I want zero rehypothecation, the prime will turn around and say no, it’s just impossible,” he says.

Ehsan Haque, head of equities legal, global markets, Nomura, adds that close alignment between the legal, credit and risk functions of a PB are key to signing off negotiations. “We have meetings regularly and get sign-off [on points of negotiation] from the relevant risk functions to make sure that terms are acceptable.”

HSBC’s Paul Hamill, global head of prime finance, agrees. “I think it’s important to get the right people around the table when you’re negotiating these agreements.”

“In addition to the lawyers, you need those people involved in the day-to-day activities of the fund and bank [to be actively involved there],” he says.

### Renegotiation/additional products

Prime brokers point out that legal agreements aren’t set in stone indefinitely, something that lawyers and managers also highlight. But is it any easier to renegotiate certain terms at a later stage?

“Managers always have the right to [try] and vary the documentation, so if their assets grow substantially, they can revisit the negotiations,” Oesa’s Wormald says.

“When we audit existing documents for people, we say you could improve on x, y or z, but if you do, the template will also have to include a or b.”

But she cautions that managers can’t always assume that, if revisiting negotiations, the prime broker won’t also ask for some amendments, and so it may not be commercially viable for managers to request certain changes, because



[Prime brokers] are the ones facing the street and putting on the trades  
Kate Wormald, Oesa Partners

overall terms may be weakened, unless the two parties have an informal understanding that certain terms can be improved as a condition of asset growth.

And while established managers that have grown may be in a better bargaining position to renegotiate terms for an existing product, they shouldn't assume that such terms will always be available for new, additional vehicles they plan to launch, one senior on-boarding specialist at a bank notes.

"The terms agreed for one fund may not be appropriate for another, depending on the asset class or geography involved," he says.

Additionally, one multi-strategy manager points out that regardless of the size of the manager, or the length of the relationship, there may be some price-related elements which are dictated by the market environment, which a prime broker has no choice but to pass on.

"As euro rates have become negative it's costing us money to keep euros anywhere, and it's certainly something we've been talking to our PBs about but they're not open to negotiating, because that cost is being passed on to them from elsewhere.

"They've got to justify their charges, and if they've got a logical argument, then you do sort of accept it," he concedes.

### Margin, rehypothecation and events of default: points of negotiation

Although by no means the only areas of discussion, margin, rehypothecation and events of default are three of the most common areas of push-back by hedge funds and their counsel.

Dechert's Bell explains that margin will be a key negotiating point for managers. "In particular, managers will be looking for as much certainty as possible on the methodology that will be used to calculate the fund's margin requirement, the types of assets and cash currencies that can be delivered as margin and the hair-cuts that will be applied."

Managers will look to negotiate some of the operational terms around how margin is delivered, such as agreeing a timeframe rather than having a requirement to deliver on demand, particularly if discretionary management is conducted across different jurisdictions and time zones.

"PBs will want as much flexibility as possible in setting the types and amount of margin," Macfarlanes' Mortlock explains. "Conversely, managers would prefer complete transparency over margin calculations and consistent amounts.

"In some circumstances managers may want to seek 'locked up' margin so that rates are known and unchangeable for a set period of time," Mortlock adds.

Getting transparency around margin calculations is important for both parties, and something Nomura has increasingly focused on over the last 18 months, Cameron says. "We've adopted a margin methodology and framework that gives clients very clear guidelines of the parameters that would increase or reduce margin [requirements] and they can work within that."

On rehypothecation, Bell notes that "it is current practice in the London market to look to cap the level some-

### ■ Dos and don'ts

- Do speak to investors about the PBs under consideration. "Managers may find some investors do not like certain PBs because they might have had a bad experience with an entity during the crisis and don't want to hold assets with them again," according to Kate Wormald, founder of Oesa Partners.
- Do discuss with counsel prior to negotiation which terms are on/off-market and form a list of those most important to be used in the initial selection process and later to be translated into the PB agreement, Macfarlanes' Tom Mortlock says.
- Don't assume the 'platinum terms' you received 15 years ago when part of a \$10bn-plus fund will remain available, Mortlock adds. "PBs have been heavily impacted by capital considerations, and their pricing and willingness to offer concessions has been affected accordingly."
- Do ensure that people involved in the day-to-day running of the business, at both the hedge fund and the bank, are actively involved in negotiations.
- Going through the documentation can be tedious, but don't rush through it, one senior on-boarding specialist says. "It's critically important to understand exactly what your rights and your obligations are, and what it means when you tick those boxes around cut-off times, delivery times and notifications."

where between 140% and 200% of the fund's obligations to the PB".

And while seeking a cap around rehypothecation is one way to mitigate counterparty credit risk concerns, there are other factors to consider too, Mortlock adds. "How are they holding unused cash and assets – would client money protection be useful?

"Can they sweep cash or assets to other entities within the broker group? Who benefits from the security interests given by the manager, and who benefits from the set-off rights?"

For certain events of default, such as a payment or delivery failure, negotiating a grace period to correct an error before it is considered an event of default can be helpful, Dechert's Bell says.

Matt Kerfoot, a New York-based partner for Dechert, adds that where possible, they try to remove cross-default events from an agreement, or to 'ring-fence' them, so they only apply within the prime broker's group, particularly with regard to a breach of representation, to ensure such an event doesn't adversely impact a hedge fund's relationships with other banks.

However, HSBC's head of sales and marketing with the European prime finance group, Joe Leckie, notes that cross-default event clauses are only enacted in "exceptional situations", and that PB agreements contain very specific language around the triggers of that, including default thresholds.

He adds that in the event of a loss to the fund, the cause is immaterial if the fund is then unable to meet its obligations in the agreed time period.

Macfarlanes' Mortlock points out that almost all PBs will push for at least one 'out' in a crisis. "They will want to be able to either terminate, dramatically increase margin or impose trading limits quickly; steps they feel necessary to protect themselves."

He suggests managers think about which 'out' is least concerning – if any – and that a concession to prime brokers here may allow flexibility on other terms. ■

# 2015 UK FINANCE ACT

By Stephen Rabel, managing director of tax at Kinetic Partners



**F**rom a hedge fund perspective, the key take-away from the UK Finance Act this year was the disguised investment management fees legislation, which took effect from 6 April.

The crackdown on disguised investment management fees is aimed at counteracting what HMRC considers to be specific tax avoidance behaviour. There are probably two approaches that the Revenue could take to ensure targeted anti-avoidance legislation doesn't result in unintended consequences: either to be specific when describing the situations they are intending to catch or to be general and include exemptions for the scenarios they are not intending to catch. The disguised investment management fees regime falls into the latter approach.

The terminology is broad, and legislation will apply where:

- An individual performs investment management services directly or indirectly under any arrangement for an investment scheme
- Arrangements involve a partnership ('involve' can have a wide meaning)
- A management fee arises

The draft legislation released in December prompted many comments that the exemptions were too specific and not broad enough. HMRC's response was to improve the exemptions. The current legislation will ensure more situations are exempted and that most commercial situations should not be impacted.

The challenge is that we are left with a broad initial formation of when certain situations may be caught and it is often difficult to cover off all future structures that wouldn't be considered avoidance. The danger is that both taxpayers and HMRC understand today what is meant to be caught and what isn't, but the legislation will not necessarily accurately reflect that. That understanding may become unclear in the future, particularly where the application of the legislation may be part of a more complex discussion with HMRC.

HMRC has issued guidance that provides more insight into their view of the legislation. It is clear that the private equity sector was of primary focus, but it is also evident that it will be wider than this where there is an attempt to disguise investment management fees such that they are not properly subject to tax.

Given the nature of the terminology above, any person involved in a structure where fees are paid by a fund, including hedge fund managers, will need to look at arrangements they may have in which partnerships are involved to assess whether they are appropriately taxed. In particular the guidance suggests that individuals who receive dividends will need to ensure they are not part of a 'contrived structure'. Additionally, HMRC notes that they will examine situations where investment management services are provided by low (or no) tax jurisdictions.

The diverted profits tax (DPT), dubbed the 'Google tax', also took effect from 6 April and could be applicable to managers who operate in multiple jurisdictions. This legislation again appears to have a clear target but given the formulation of the legislation it could have a much wider impact than the publicised intention, even with certain exemptions.

The tax charged at 25% on diverted profits has two basic charging provisions. The first charge seeks to address avoidance of a UK taxable presence, imposing a charge on a non-resident company making sales to UK customers where no permanent establishment exists and, in some cases, even where it does. This is the type of provision most anticipated to counter tax-motivated arrangements for firms such as Google. There is a specific exemption here for investment managers.

However, the second charge focuses on avoidance utilising entities or transactions lacking economic substance, which may impact a greater proportion of taxpayers. This charge looks at scenarios where either income is suppressed or those where expenses are imposed or increased, an area typically covered solely by transfer pricing. Taxpayers operating internationally should review to what extent they fall within the legislation and specifically for smaller businesses whether the exemptions will be applicable.

Additionally, unlike income and corporation tax, the diverted profits tax will not fall under the typical self-assessment regime, with much of the power and responsibility in determining amounts due resting with HMRC. Taxpayers will have a duty to notify HMRC of the possible application of the DPT and have recourse to disagree with that application, but the legislation is firmly weighted to the advantage of the tax authorities. ■

**HFM COMPLIANCE  
PEER  
REVIEW  
AIFMD**

**E**very month *HFMCompliance* offers its readers the chance to answer questions on compliance, regulatory and operational matters, which are later benchmarked against your peers when we reveal the results in each issue. This month, we polled firms on recent AIFMD decisions from regulators.

Over half (56%) of hedge fund managers surveyed by *HFMCompliance* thought the FCA's determination on 30 March that external valuers cannot be held liable under the Directive was potentially concerning.

Under the AIFMD, valuations can be performed by either an external valuer or the AIFM itself as long as the task is "functionally independent" from portfolio management, remuneration policy and other conflicts of interest.

In its quarterly consultation, the FCA said the party making the final determinations on valuing assets – the manager – is considered to be performing the valuation function for a fund.

On the upside, these managers also thought more administrators might offer the external valuer service with this added assurance they could only be sued if acting negligently. Centaur, Citco and Mitsubishi are the only admins currently offering an external valuation service and *HFMCompliance* understands this is strictly to their own clients.

The German regulator, which came under fire this week for inconsistent messages to the industry, as reported on page 4, also made an AIFMD-related proclamation in March.

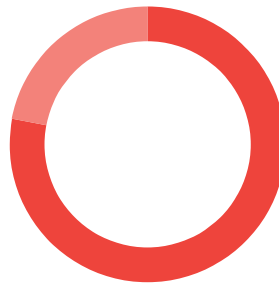
German AIFMs were due to report on 16 March, but it has now been delayed until mid-May and only a test system

**Q1** DOES THE FCA'S DETERMINATION THAT EXTERNAL VALUERS CANNOT BE HELD LIABLE UNDER THE AIFMD CONCERN YOU?



- No, we were not planning on using an external valuer **22%**
- Maybe, but we may see more admins offer this service due to the reassurance **56%**
- Yes, negligence will be extremely difficult to prove **22%**

**Q2** GERMANY ANNOUNCED IT HAD DELAYED AIFMD REPORTING AGAIN IN MARCH. IS THIS PROBLEMATIC?



- Yes, it confirms that EU countries were not ready to accept reports on-time despite expecting managers to **78%**
- Maybe, it's more worrying that Esma has not yet readied its system to accept the data **22%**
- No, the longer we have to wait to file the better **0%**

will remain in its place. The Federal Financial Supervisory Authority (Bafin) has already delayed its test by one month after being hit by its own technical issues.

More than three-quarters of managers responding to the monthly survey said the delay was problematic and confirmed that EU regulators were not ready to accept reports on-time despite expecting managers to file on-time.

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