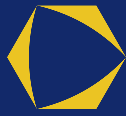

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Private Funds Newsletter

Issue 1 of 2010: January

Regulatory Standards for Funds of Hedge Funds 1

Changes in CFTC Regulation for Non-US Pools 2

Ireland to Introduce Legislation Enabling Non-Irish Fund Companies to Redomicile into Ireland on the Basis of Continued Corporate Existence 2

Legislation Increases Withholding Tax Exposure for Certain Investors in U.S. Securities 3

Impact of the IOSCO Report on Unregulated Financial Markets and Products 3

SFC Survey on Hedge Fund Activities 4

Deacons Financial Services Seminar Series 4

Regulatory Standards for Funds of Hedge Funds

The Technical Committee of the International Organization of Securities Commissions (IOSCO) recently issued a final report on international regulatory standards for funds of hedge funds (FHFs) based on best market practices. IOSCO proposed some standards which reflect a common approach in the industry in two particular areas: (1) the methods by which FHF managers deal with liquidity risk; and (2) the nature and conditions of due diligence process used by FHF managers prior to and during investment.

Looking at liquidity risk, IOSCO recommended that an FHF manager should make reasonable enquiries to enable it to consider whether the FHF's liquidity is consistent with that of the underlying hedge funds (*general principle I.1*) and should also consider the liquidity of the types of financial instruments held by the underlying hedge funds (*general principle I.2*). Another key issue for the FHF manager to consider is conflicts of interest between an underlying hedge fund and investors (*general principle I.4*).

IOSCO also recommended that if the FHF manager decides to implement limited redemption arrangements (such as redemption gates or redemption deferrals), it should consider whether such arrangements are consistent with the aims and objectives of the FHF. The limited redemption arrangements should be activated only for a limited period of time and for the purpose of dealing with exceptional situations which are clearly specified in the prospectus and such decision should be made on a collegial basis by the investment committee of the FHF (*general principle I.3*). Limited redemption arrangements are regarded as a useful tool to manage the liquidity of an FHF. Liquidity of an FHF depends on any lock up requirement, redemption frequency, notice period and restrictions of the underlying hedge funds. Although many managers may prefer more flexibility in implementing this tool, it is important for the purposes of investors' information and protection to disclose clearly in the prospectus the exceptional situations and the conditions under which the limited redemption arrangements may be imposed.

Changes in CFTC Regulation for Non-US Pools

By Ethan W. Johnson and Natalia A. Napoleon of Morgan, Lewis & Bockius LLP

The U.S. Commodity Futures Trading Commission (CFTC) generally requires financial statements for commodity pools to be presented and computed in accordance with U.S. generally accepted accounting principles (GAAP). Over the years, the CFTC has provided limited relief from this requirement to commodity pool operators (CPOs) and permitted the financial statements of their non-U.S. pools to be presented in accordance with International Financial Reporting Standards (IFRS). The CPOs were required to submit written requests for relief and had to include statements in the pools' financial statements (so-called "reconciliation statements") setting forth the primary differences between IFRS and GAAP-based accounting.

The CFTC recently adopted changes to their regulations that remove the requirement that registered CPOs file annual reports in accordance with GAAP and, under amended Section 4.22, permit a registered CPO to file IFRS-based financial statements for non-U.S. pools. In addition, CPOs that have filed for the Commodity Exchange Act Section 4.13 exemption will no longer need to request permission from the CFTC in order to present financial statements in accordance with IFRS. Further, the GAAP reconciliations statements that were previously required will no longer be necessary. It is not clear at this time how these changes will affect CPOs that are eligible for exemption under Section 4.13 but have not filed the notice of exemption with the CFTC.

With respect to registered CPOs, notice must be filed with the CFTC within 90 days of the end of each non-U.S. pool's fiscal year in order for such CPOs to present IFRS-based annual reports. The notice must indicate compliance with the following conditions: (i) the annual report will include either a condensed schedule of investments or, if required by IFRS, a full schedule of investments; (ii) the preparation of the pool's financial statements under IFRS will not be inconsistent with representations set forth in the pool's offering memorandum or other operative documents; (iii) special allocations of ownership equity (such as performance allocations) are reported in accordance with Section 4.22(e)(2) of the Commodity Exchange Act; and (iv) in the event that IFRS requires consolidated financial statements, such as consolidating the financial statements of a feeder with its master fund, all applicable disclosures required by GAAP for the feeder fund must be presented with the reporting pool's consolidated financial statements.

The foregoing amendments allow exempt CPOs to prepare their pools' annual reports without adhering to CFTC-prescribed accounting standards and, further, permit both exempt and registered CPOs to avoid the expensive and difficult process of preparing GAAP reconciliations for non-U.S. pools.

For additional information, please contact Ethan W. Johnson at ejohnson@morganlewis.com or Natalia A. Napoleon at nnapoleon@morganlewis.com

Ireland to Introduce Legislation Enabling Non-Irish Fund Companies to Redomicile into Ireland on the Basis of Continued Corporate Existence

By Declan O'Sullivan of William Fry

In response to the recent and anticipated European legislative developments in the asset management arena, the Irish Government has introduced a number of measures that will enhance Ireland's position as a leading fund domicile, particularly for hedge funds.

One of these measures is legislation enabling non-Irish fund companies to redomicile into Ireland on the basis of continued corporate existence. Draft legislation to this effect was published on 9 December 2009 and it is expected to be enacted shortly.

The principal feature of the new redomiciliation process is that it will not involve the winding up of one fund company and the creation of another. Essentially, a non-Irish fund company will continue its existence as a company registered under Irish law. This new process compares very favourably with other jurisdictions, such as Luxembourg, which permit redomiciling of fund companies, as there will be no requirement for an EGM to be held in Ireland.

One of the key advantages for fund companies availing of the new redomiciliation process is the fact that it will allow the fund company to maintain its track record and listing history, which would not be possible if a new corporate structure was created. In addition, continued corporate existence will not normally create a charge to capital gains as no disposal takes place for tax purposes for investors in the fund company.

The regulatory requirements for redomiciling a migrating company to Ireland will be straightforward and will be based principally on statutory declarations made by a director of the migrating company submitted to the Irish Registrar of Companies. The migrating fund company will also have to be authorised and regulated by the Irish Financial Regulator.

The new redomiciliation process is expected to be of particular interest to promoters who wish to redomicile their offshore funds to a regulated, well-serviced OECD and EU jurisdiction. In particular, the legislation will benefit hedge fund managers seeking to avail of the distribution opportunities afforded by the UCITS Directive and for those preparing for the introduction of the Alternative Investment Fund Managers Directive, which currently contemplates the granting of an EU marketing passport to EU domiciled funds only.

For additional information, please contact Declan O'Sullivan at declan.osullivan@williamfry.ie

Legislation Increases Withholding Tax Exposure for Certain Investors in U.S. Securities

By Dominique P. Gallego of Schulte Roth & Zabel LLP

The Tax Extenders Act of 2009 (Bill) was passed by the U.S. House of Representatives on 9 December 2009. To raise revenue and prevent tax avoidance by U.S. persons hiding financial assets abroad, the Bill includes a new 30% withholding tax regime, distinct from the existing withholding rules, on foreign persons who invest in U.S. securities and fail to comply with information gathering and reporting requirements.

The new withholding tax would be imposed on U.S. source payments to "foreign financial institutions" (including offshore investment funds) (FFI) unless the FFI agrees with the U.S. Internal Revenue Service (IRS) to, among others, (i) obtain information regarding each of its account holders (including fund investors) regarding direct or indirect U.S. ownership of the account, and employ due diligence/ verification procedures as required, (ii) annually provide detailed information (e.g., name, address, tax identification number, account number, account balance, gross receipts, gross withdrawals and payments) on any such U.S. account to the IRS, (iii) withhold 30% of any U.S. source payment to an account holder who fails to provide the necessary information, and (iv) obtain waivers of foreign law confidentiality protection from such account holders. Under the Bill, almost every non-U.S. hedge fund would be required to enter into an agreement with the IRS under which it collects information in respect of its investors' direct and indirect U.S. ownership; otherwise, 30% of the gross proceeds, not just income, in respect of its U.S. stocks and debt investments, among other U.S. source payments, would be withheld as U.S. tax. If an FFI is the beneficial owner of a payment that has been withheld on where such FFI is not resident in a treaty jurisdiction, the withholding tax is nonrefundable and noncreditable.

U.S. source payments to non-U.S. persons which are not FFIs are subject to a similar withholding tax, if the beneficial owner fails to certify that such owner has no substantial U.S. owners or fails to provide detailed information relating to any substantial U.S. owner. Payments beneficially owned by governments (including any political subdivision or any wholly-owned agency of such government) are exempt. If enacted, the withholding provisions would apply to payments made after 31 December 2012. Payments on obligations outstanding 2 years after the date of enactment are also grandfathered and not subject to the new withholding rules.

The Bill impacts any non-U.S. investor in U.S. securities, even investment funds advised by non-U.S. managers. Financial institutions and investment fund managers who invest in U.S. securities should keep track of the Bill's development because its enactment will impose a significant information collection and compliance burden not previously undertaken.

For more information, please contact Dominique P. Gallego at dominique.gallego@srz.com or Shlomo Twerski at shlomo.twerski@srz.com

Impact of the IOSCO Report on Unregulated Financial Markets and Products

The recent Final Report of the Technical Committee of the International Organization of Securities Commissions (IOSCO) on Unregulated Financial Markets and Products focuses on the systematically important securitisation and credit default swap (CDS) markets. It examines how greater transparency and oversight can be introduced in such markets and recommends regulatory approaches that regulators may implement to improve market quality and restore investor confidence.

Although the Task Force on Unregulated Financial Markets and Products acknowledged the value of industry initiatives to strengthen these markets, it noted that such initiatives have limits, given the magnitude of the global financial crisis and should, where appropriate, be supplemented and supported by regulation.

On securitisation, IOSCO recommends, *inter alia*, (i) that the "originate-to-distribute" model be replaced with a system requiring originators and/or sponsors to retain long-term economic exposure to the securitisation in order to align interests appropriately in the securitisation value chain, (ii) disclosure by issuers to investors of the verification and risk assurance practices that were performed or undertaken, (iii) regulatory support for improvements in disclosure by issuers to investors of underlying asset pool performance and certain other risks, and (iv) the review, and if required, the strengthening of, investor suitability requirements. It was also noted that the inadequate risk management practices of investors may be mitigated by imposing an obligation on distributors to ensure that the product is suitable for the investor.

On CDS, IOSCO recommends, *inter alia*, that
(i) central counterparties should be established and should be regulated with robust risk management practices and financial resources to clear standardised CDS,
(ii) financial institutions should be encouraged to standardise CDS contracts, and (iii) regulators should facilitate the timely disclosure of CDS data such as price, volume and open-interest.

Although the recommendations in the Report may not be entirely suited to the market practice or environment of individual jurisdictions, it should be noted that the implementation of the recommendations at national level is largely left to local regulators, since each "jurisdiction should assess the scope of existing regulatory parameters and may need to expand that scope only to the extent necessary…".

SFC Survey on Hedge Fund Activities

The SFC has published its second survey of Hong Kong's hedge fund industry. The findings, providing a snapshot of Hong Kong's hedge fund industry as at 31 March 2009, offer instructive data on the development of the industry since the previous survey in 2006.

The 2009 survey includes statistics on the size of the industry which demonstrate healthy growth: 541 hedge funds were managed by SFC-licensed managers; and assets under management (AUM) stood at US$55.3 billion.

As for investment approaches, the SFC reported managers were adopting a relatively conservative stance amid the financial crisis: 28.5% of the total AUM was held in cash, deposits or money market instruments compared to a reported figure of 4% in 2006; and 68.8% of the hedge funds had leverage of 100% or less.

The SFC also reported that the use of side pockets was "not pervasive" with 12.1% of managers using side pockets for illiquid or hard-to-value investments. Side letter arrangements are more common, with 43.4% of managers reporting fee rebate arrangements with investors.

In the report, the SFC took the opportunity to highlight its initiatives in the past three years in response to the growth and changing landscape of the Hong Kong hedge fund industry. The initiatives include adopting, in 2007, streamlined measures for processing licensing applications for hedge fund managers. The SFC reports that the new procedures have reduced the average processing time by above 40%, from twelve weeks in June 2007 to seven weeks in August 2009.

Deacons Financial Services Seminar Series

The upcoming seminar in our 2010 Financial Services Series will be held on **Wednesday, 3 March 2010** in our Hong Kong Office.

Topic	**Current Regulatory Issues for Private Investment Funds**
Speakers	**Rory Gallaher**, Partner, Financial Services Practice Group, Deacons **Karen Kaur**, Partner, Financial Services Practice Group, Deacons **Jane McBride**, Partner, Financial Services Practice Group, Deacons
Language	English
CPD points (Law Society)	One CPD point has been applied for
CPT points (SFC)	CPT attendance certificates will be available on request
Fee	Complimentary
Time	1:00 – 2:00pm (registration starts at 12:30pm)
Venue	Deacons, 14th Floor, Alexandra House, 18 Chater Road, Central
RSVP	Please send an email to deacons.rsvp@deacons.com.hk to reserve a place by Friday, 12 February 2010

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Whilst every effort has been made to ensure the accuracy of this publication, it is for general guidance only and should not be treated as a substitute for specific advice. If you would like advice on any of the issues raised, please speak to any of the contacts listed.

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