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roundtable

2011 Annual Private Fund Investors Roundtable

topic

Update on Regulatory and Tax Initiatives

speakers

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Overview

- Dodd-Frank Regulations – Form PF
- Pay-to-Play, New Issues and Other Regulatory Developments
- The European Regulation of Alternative Investment Fund Managers (AIFM)
- FATCA and FBAR

Dodd-Frank Financial Reform

- Dodd-Frank Wall Street Reform and Consumer Protection Act
  - All advisers to "private funds" must register, subject to certain exceptions
  - "Private fund" is any issuer that relies on Section 3(c)(1) or (c)(7), includes private equity funds
  - Eliminates Section 203(b)(3) exemption for fewer than 15 clients

Dodd-Frank Financial Reform (continued)

- "Mid-sized" adviser must register with states or the SEC
  - Advisers with more than $25 million but less than $100 million will register with the SEC only if the states in which their principal offices are located do not require registration and supervision
- Advisers to "small private funds" are not required to register
  - Advise exclusively private funds
  - Private funds have aggregate AUM of less than $150 million

Dodd-Frank Financial Reform (continued)

  - Must keep records and provide annual or other reports to the SEC
- Advisers to "venture capital funds" are not required to register
  - Must keep records and provide annual or other reports to the SEC
- "Foreign private advisers" are not required to register
  - No place of business in U.S.
  - Fewer than 15 U.S. clients within last 12 months

Dodd-Frank Financial Reform (continued)

  - Less than $25 million in AUM from U.S. clients within last 12 months
  - Does not hold itself out in U.S.
  - Does not act as investment adviser to a registered investment company or business development company
- A foreign adviser may also qualify as an exempt reporting adviser and not need to register if the adviser:
  - Has no place of business in U.S. from which it manages funds

Dodd-Frank Financial Reform (continued)

– Has no clients that are U.S. persons (i.e., no U.S. managed accounts)

– Does not hold itself out in U.S. as an investment adviser

– Does not act as investment adviser to a registered investment company or business development company

Dodd-Frank Financial Reform (continued)

- An exempt reporting adviser will be required to file Part 1 of Form ADV and respond to a limited number of items in that form but will otherwise not be required to register with the SEC regardless of how many U.S. persons invest, or how much money they invest, in its private funds.
- Regulation PF – Establishes a system for collection of investment data about private funds

Dodd-Frank Financial Reform (continued)

- Regulation PF – Establishes a system for collection of investment data about private funds
- Applies to registered advisers who manage private funds, and provides for significantly more detailed reporting than required of registered funds or advisers who manage separate accounts
  - Different reporting requirements depending on size of funds:
    - *Quarterly for AUM over $1B*
    - *Annually for AUM between $150M and $1B*

Dodd-Frank Financial Reform (continued)

- Different reporting requirements depending on type of fund:
  - *Hedge Funds*
  - *Private Equity Funds*
  - *Liquidity Funds*

- Among the key types of information to be collected:
  - Amount of AUM
  - Use of leverage, including off-balance sheet leverage
  - Counterparty credit risk exposures

Dodd-Frank Financial Reform (continued)

  - Trading and investment positions, including VaR calculations
  - Trading practices
  - Other information as SEC determines necessary or appropriate for the protection of investors or for the assessment of systematic risk
- Signatory must certify that information is true and false statements or omission must result in revocation of license or criminal prosecution

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Dodd-Frank Financial Reform (continued)

- Additional information – registered and unregistered advisers
  – SEC authority to require additional information based on public interest and systemic risk
- Disclosure – registered advisers
  – SEC authority to require registered advisers to provide such reports, records and other documents to investors, prospective investors, counterparties and creditors of private funds
- Books and records
  – Records and reports of private funds are considered books and records of the adviser

Dodd-Frank Financial Reform (continued)

- Client anonymity
  - Elimination of provision that prohibited SEC from requiring disclosure of the identity, investments and affairs of clients
- Information sharing and confidentiality
  - SEC authority to share information with Federal Reserve Board and other entities responsible for monitoring systematic risk, subject to confidentiality requirements
  - SEC may not be compelled to disclose any report or other information filed with the SEC, except for Congress, federal departments and agencies, SROs and courts

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SEC Rules – Pay-to-Play

- **An Adviser Cannot:**
  - Be compensated by a government entity for advisory services within two years after it or its covered associate contributes to an official of the government entity
- **An Adviser and its Covered Associates Cannot:**
  - Pay someone to solicit a government entity for advisory services unless such person is a "regulated person" or an executive/manager or employee of the adviser

SEC Rules – Pay-to-Play

  - Coordinate (or solicit a person or PAC to make) (i) contributions to an official of a government entity or (ii) payments to a state or local political party, where the adviser is providing or seeking to provide advisory services
  - Do anything indirectly that, if done directly, would violate the Rule

- **The $150/$350 Exception.** Natural person covered associates can contribute $350 per official, per election (if they can vote for the official) and $150 per official, per election (if they cannot vote for the official)

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SEC Rules – Pay-to-Play (continued)

- **The New Covered Associate Exception.** New covered associates (either by way of hiring or promotion) who will not solicit clients for the adviser are only subject to a 6-month "look-back"

- **The Corrected Contribution Exception.** If a covered associate makes a prohibited contribution of no more than $350, which is discovered within four months and re-collected within 60 days of discovery, then the "two-year timeout" will be lifted

SEC Rules – Pay-to-Play (continued)

- BUT – there is a 3-2-1 limit on this exception. An adviser can only rely on this **3** times per year (or **2** times per year if it has less than 50 employees) and each covered associate only gets **1** strike

- The Rule applies to advisers who manage or solicit government assets *through* a "covered investment pool"
  - Registered funds (i.e. mutual funds) that are investment options in participant-directed government plans/programs (i.e. college saving or retirement plans)

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SEC Rules – Pay-to-Play (continued)

    - *Including government-selected funds that are part of a participant-selected "model portfolio"*
  - Funds that would be registered, but for 3(c)(1), (7) or (11) (i.e. hedge, private equity and venture capital funds and collective investment trusts)
- **Prohibited:** Adviser may not receive compensation from a government entity for advisory services within two years after it or its covered associate contributes to an official of the government entity

SEC Rules – Pay-to-Play (continued)

- Policy considerations:
  - Consider how broadly you want to define “covered associates.” Those with “economic incentive” must be covered
  - Remember new hires, acquired advisory firms and promoted employees can bring their time-out with them
  - Consider whether you want to define “government entities” and “officials” or put the onus on requesting employees
  - Permit individual contributions to federal candidates (unless incumbent state officials) and to national, state or local political parties and PACs

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SEC Rules – Pay-to-Play (continued)

  - Not carve out "intent of influencing contracts" – the test under the Rule is merely the intent of influencing election (low threshold)
  - Consider that substance, rather than job titles and organizational structure, may be determinative
- **Prohibited:** Payments from an adviser or covered associate to someone to solicit a government entity for advisory services, unless such person is a "regulated person" or an executive/manager or employee of the adviser

SEC Rules – Pay-to-Play (continued)

- **The gist:** anyone paid for solicitation must be subject to pay to play rules
- Policy considerations:
  - Take into account the pending changes to the Rule, which could prohibit paying third-party affiliates for solicitation
  - Ban covered associates from paying anyone for solicitation
  - Limit adviser payments for solicitation to an approved list of solicitors

SEC Rules – Pay-to-Play (continued)

  - Require "regulated persons" (or "regulated municipal advisors") to prove qualification under the Rule or establish dialogue procedures
  - Require periodic certifications from covered associates

- **Prohibited:** Adviser and its covered associates may not coordinate (or solicit a person or PAC to make) (i) contributions to an official of a government entity, or (ii) payments to a state or local political party, where the adviser is providing or seeking to provide advisory services

SEC Rules – Pay-to-Play (continued)

- **The gist:** cannot target aggregated contributions (i.e. bundling, gatekeeping) toward a current or hoped-for government client
- Policy considerations:
  - Ban covered associates from coordinating/soliciting contributions
  - Permit covered associates to make independent, individual contributions to state or local political parties below the *de minimis* threshold
  - Enumerate limited circumstances in which adviser could coordinate or solicit contributions, checked against a list of current and possible clients

SEC Rules – Pay-to-Play (continued)

- March 14, 2011
  - Advisers (other than advisers to registered investment companies that are covered investment pools) subject to the Rule must be in compliance
  - Advisers subject to Rule 204-2 (other than advisers to registered investment companies that are covered investment pools) must be in compliance with amendments to Rule 204-2

SEC Rules – Pay-to-Play (continued)

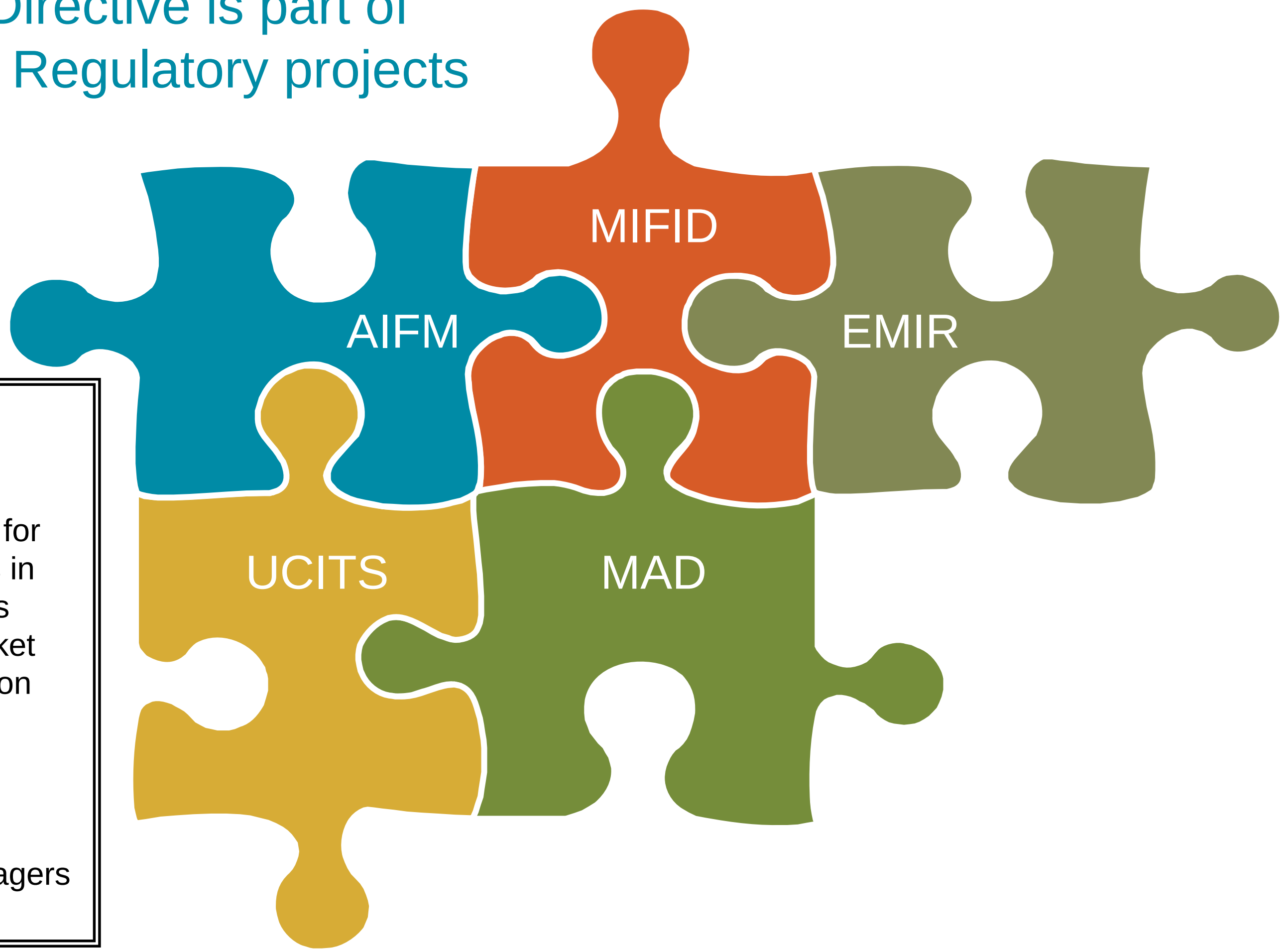
- September 13, 2011
  - Advisers may no longer use third parties to solicit government business except in compliance with the Rule
  - Advisers to registered investment companies that are covered investment pools must comply with the Rule and with amendments to Rule 204-2 with respect to those registered investment companies

The European Regulation of Alternative Investment Fund Managers Summary

- AIFM in context
- Scope of Application
- Third Country Provisions
  - *Introduction of the Passport Principle*
  - *Distribution of non-EU AIFs in the EU*
  - *Admission of non-EU AIFMs in the EU*
- Key Provisions of the AIFM Directive
- Implementation

AIFM in context

The AIFM Directive is part of several EU Regulatory projects



LEGEND
MAD - Market Abuse Directive
UCITS - Undertakings for Collective Investments in Transferable Securities
EMIR - European Market Infrastructure Regulation
MiFID - Markets in Financial Instruments Directive
AIFM - Alternative Investment Fund Managers Directive

Scope of Application

- AIFM Directive regulates (i) the registration and operational requirements for AIFMs, and (ii) the distribution of AIFs to professional investors
- AIFM Directive covers all fund managers that operate funds that do not fall under UCITS
- AIFM Directive covers hedge funds, private equity funds, open and closed ended funds irrespective of where the fund
  is located or how it is organized
- Exemptions apply to AIFMs that control assets of less than €100 million in value or less than €500 million in value if the funds do not use leverage and exclude redemption rights for investors for 5 years

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Third Country Provisions

- Introduction of the Passport Principle
  - Introduction of the passport principle opens the door for non-European AIFMs and non-European AIFs
  - Innovative approach that has not been tested and is not included in other Directives (e.g. UCITS or MIFID)
- Distribution of non EU-AIFs in Europe
  - Possibility to passport non EU-AIFs throughout Europe, if:
    - *Fund manager complies with the AIFM Directive,*

Third Country Provisions

- *Cooperation agreements exist between regulatory authority of the home country of the AIFM and the authorities of the Member State of Reference*
- *Double tax treaty exists between the third country and the Member State of Reference*

– Supervision of compliance with the AIFM Directive by the Member State of Reference

– Passport provisions will become effective 2 years after implementation of AIFM Directive (i.e. not before 2015)

Third Country Provisions

  - National private placement rules of Member States will apply in parallel until 2018
- Admission of non-EU AIFMs in the EU
  - Non-EU AIFMs need to be licensed in the Member State of Reference
  - License depends on whether or not the home country of the AIFM complies with certain minimum legal standards (applicable standards depend on the type of business the non-EU AIFM intends to conduct in the EU) and cooperates sufficiently with the competent European authorities

Third Country Provisions

  - AIFM needs to comply with provisions of the AIFM Directive with respect to its European activities
  - License may be used throughout the EU
- License for the AIFM depends on:
  - Ability to comply with the AIFM Directive
  - Minimum capital requirements (at least €125,000)
  - Reliability and qualification of management of the AIFM
  - Reliability of shareholders of the AIFM
  - Administration and incorporation of the AIFM in one and the same Member State

Key Provisions of the AIFM Directive

- Conditions and operation of fund administration
  - Avoidance of interest conflicts
  - Establishment of risk management system separate from portfolio management
  - Monitoring of compensation policy for key employees in accordance with principles established by AIFM Directive and future implementing regulations
  - Establishment of liquidity risk management system
  - Independent evaluation of funds assets once a year
  - Depository requirement/depository liability
  - Notification requirement for outsourcing arrangements
  - Restrictions on the use of leverage

Key Provisions of the AIFM Directive

- Disclosure obligations
  - Disclosure obligations vis-à-vis Competent National Authority, e.g.:
    - *Arrangements for liquidity management*
    - *Risk profile of the fund*
    - *Main categories of fund assets*
    - *Performance data and results of stress tests*
  - Disclosures prior to investment include e.g.:
    - *Investment strategies*
    - *Legal structure*
    - *Procedures to change investment strategy*
    - *Applicable law and jurisdiction*
    - *Material arrangements*

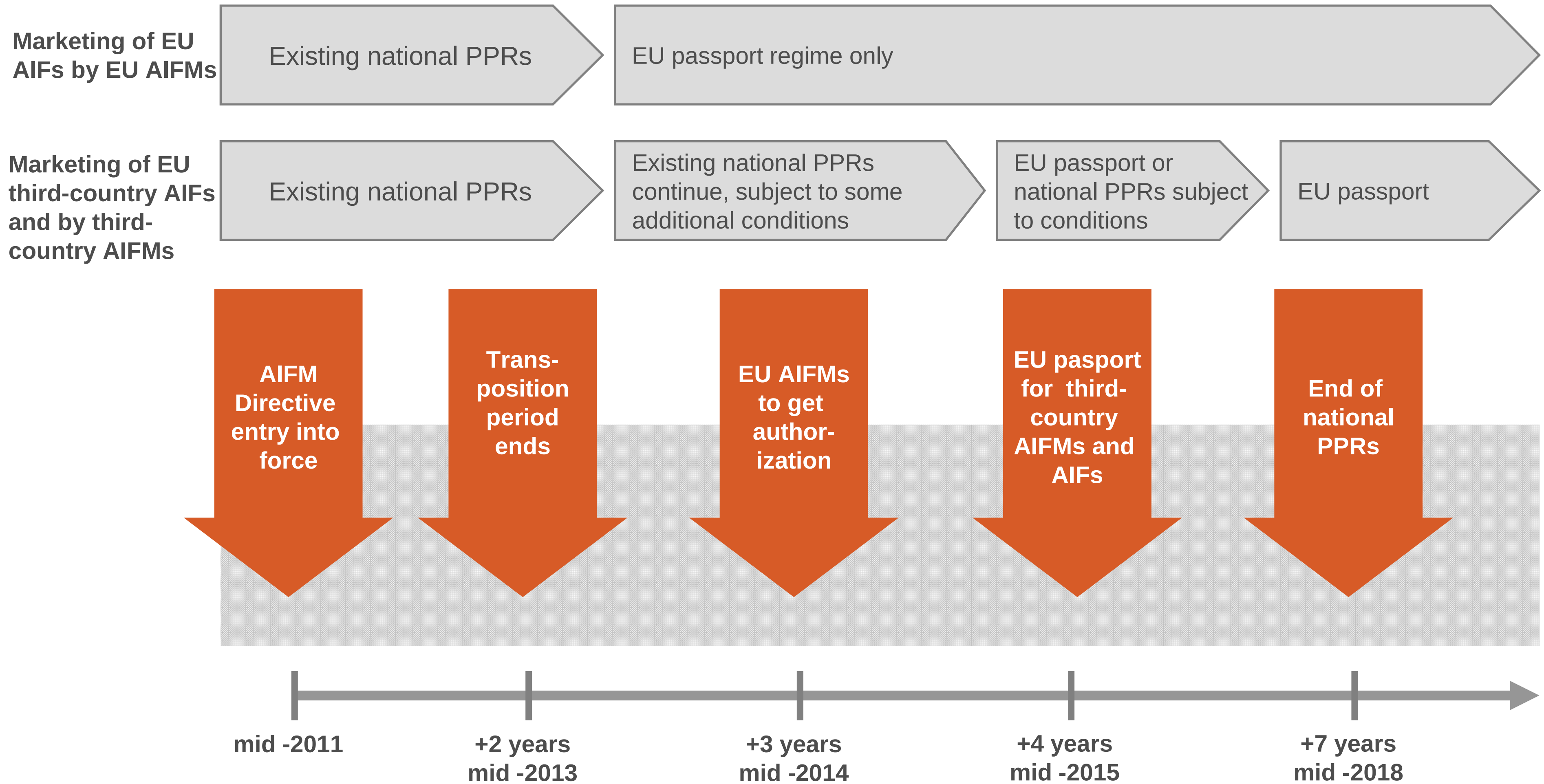
Key Provisions of the AIFM Directive

- Disclosure obligations vis-à-vis investors
  - Regular disclosures include e.g.:
    - *Special arrangements with respect to assets*
    - *Arrangements with respect to liquidity management*
    - *Risk profile*
    - *Identity of depository, auditor and other special service provider*
    - *Evaluation methods*
    - *Leverage*
    - *Conflicts of interest*
    - *Outsourcing arrangements*

Key Provisions of the AIFM Directive

- Special rules for private equity funds
  - Regulation/prohibition of asset stripping
  - Specific disclosure requirements

Implementation



FATCA–Overview

- The Hiring Incentives to Restore Employment Act of 2010 (the "HIRE Act"), enacted March 18, 2010, added new Sections 1471 through 1474 of the U.S. Internal Revenue Code.
- These new sections are commonly referred to as the "FATCA" provisions (reflecting the name of a predecessor proposal, the Foreign Account Tax Compliance Act).
- The broad goal of FATCA is to use the threat of significant withholding tax to require disclosure of the identity and extent of ownership in U.S. investments, through non-U.S. entities, of U.S. persons.

FATCA—Limited and complicated guidance

- The FATCA provisions go into effect January 1, 2013
- IRS has issued preliminary guidance in two lengthy notices (100 +pages), Notice 2010-60 and Notice 2011-34
- Definitive guidance, forms and instructions are to follow, and many questions remain

FATCA—Withholding

- Under FATCA, a new U.S. 30% withholding tax is imposed
  - on a wide variety of “withholdable payments” made to “foreign financial institutions” (“FFIs”) unless they enter into agreements with the IRS and become “participating FFIs” and to “non-financial foreign entities” (“NFFEs”) unless they provide information as to their U.S. owners
  - on “passthrough payments” made by participating FFIs to NFFEs unless they provide information as to their U.S. owners and to other certain other persons that don’t confirm their U.S. status.

FATCA—Withholdable Payments

- Withholdable payments covers a broad range of payments from U.S. investments, including:
  - The sort of "fixed or determinable annual or periodic" ("FDAP") payments that are currently subject to U.S. withholding tax (e.g., dividends and interest from U.S. sources); and
  - Gross proceeds from investments that could result in U.S. source income (e.g., proceeds from sale of stock of U.S. corporations).
- Withholding exceptions otherwise available (e.g., portfolio interest, tax treaties) don't apply.

FATCA—Foreign Financial Institutions

- Along with banks and broker-dealers, a wide variety of investment funds are treated as "foreign financial institutions," or "FFIs," under FATCA, including mutual funds, fund-of-funds, exchange-traded funds, hedge funds, private equity and venture capital funds and commodity pools.

FATCA—Participating and non-participating FFIs

- An FFI will be required to become a "participating FFI" by entering into an agreement with the U.S. IRS, pursuant to which it agrees to gather and report information about its U.S. investors to the IRS.
- If an FFI does not enter into a FATCA agreement with the IRS, it will be a "non-participating FFI" and itself will become subject to the 30% FATCA withholding tax on withholdable payments.

FATCA—Withholding on Investors

- A participating FFI will be required to collect 30% FATCA withholding tax with respect to “passthrough payments” it makes to non-partipating FFIs or to NFFEs that don’t provide information as to their U.S. owners.
- Exceptions apply to certain NFFEs, including
  - Publicly traded corporations
  - Foreign governments
  - Central banks or international organizations

FATCA—Evaluating Investors

- Various exceptions and presumptions may apply in guiding an FFI as to whether its non-U.S. investors are subject to FATCA withholding tax:
  - Investment is less than $50,000
  - Indications of U.S. status, such as a mailing address
- These may be of limited relevance to the typical investment fund.

FATCA—Recalcitrant Investors

- In general terms, a foreign entity that isn't a FFI is a NFFE, and will be viewed as "recalcitrant" and subject to 30% FATCA withholding, unless it provides information to a participating FFI as to its U.S. owners or certifies that it has no substantial (generally over 10%) U.S. owners, or with respect to funds, that it has no U.S. owners.
- Reporting exceptions for U.S. publicly traded corporations, tax-exempts, government entities, banks, RICs and REITS.

FATCA—Calculation of Withholding on Investors

- A participating FFI is required to subject passthrough payments to recalcitrant investors to 30% FATCA withholding.
- Passthrough payments equal:
  - (i) the amount of the payment that is a withholdable payment plus
  - (ii) the amount of the payment that is not a withholdable payment, multiplied by the FFI's "passthrough payment percentage."

FATCA—Passthrough Payment Percentage

- A participating FFI's "passthrough payment percentage," calculated on a quarterly basis, equals the percentage of the FFI's assets that are viewed as U.S. (in general terms, that could result in payments subject to FATCA withholding).
- A participating FFI will be obligated to "publish" its passthrough payment percentage on its website (with the percentage assumed to be 100% for a participating FFI that does not publish a percentage).

FATCA--Exceptions

- A narrow group of FFIs will be “deemed compliant” without entering into agreements with the IRS.
- To be a deemed compliant FFI, (i) all holders of record of direct interests in the FFI must be participating FFIs, deemed compliant FFIs, or fit within other narrow categories (e.g., foreign central banks or governments and international organizations), (ii) investors that don’t fit within those categories aren’t permitted to hold interests in the FFI and (iii) the deemed compliant FFI certifies that it will publish its passthrough payment percentages.
- Affiliated FFIs may be permitted or required to enter into a single agreement with the IRS.

FATCA—Implications for Fund Investors

- Foreign fund investors will be required to disclose information as to the extent and identify of their non-U.S. owners.
- Any investor, U.S. or foreign, in a foreign fund that makes any investments in the U.S. will be at risk of the indirect cost of FATCA withholding imposed on the fund, if the fund does not enter into an agreement with the IRS and become a participating FFI or fails to comply with the complex rules regarding FATCA.

FATCA—Implications for Fund Investors (continued)

- Fund documents may require additional certifications and indemnifications from fund investors, requiring that investors viewed as “responsible” for FATCA withholding imposed on the fund pay the resulting cost and permitting expulsion of such investors from the fund.

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FBAR—Overview

- Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, commonly referred to as “FBAR,” requires U.S. persons to report, prior to June 30 of each year, certain financial interests in, and signature authority over, certain non-U.S. accounts.
- FBAR is administered by the Financial Crimes Enforcement Network (“FinCEN”), a division of the U.S. Treasury (and not by the U.S. IRS).
- FinCEN issued extensive new regulations regarding FBAR on February 24, 2011, and has revised the FBAR form and instructions to reflect these new regulations.

FBAR—Application to Funds

- Under the revised regulations, interests in foreign mutual funds are covered by FBAR, but interests in private investment funds (meaning funds that do not issue shares "available to the general public") are not subject to FBAR.
- FinCEN is reserving the ability to extend FBAR to private funds in the future.

FBAR—Signature Authority Filing Requirements

- U.S. persons with signature authority over non-U.S. accounts (e.g., bank accounts) of funds and investors also should consider carefully whether they are obligated to make FBAR filings with respect to this signature authority.
- FinCEN has clarified that signature authority requires the ability, together or with others, to control the disposition of funds in an account.
- A U.S. individual required to file an FBAR (including reflecting signature authority) is also required to reflect this on the individual's personal income tax return.

FBAR—Narrow Exception

- A narrow exception applies to the FBAR filing requirements for a U.S. person that is employed by a publicly traded company or its U.S. subsidiary, and has signature authority over its employer's non-U.S. bank account, where the U.S. company is itself filing an FBAR.
- Note that this exception does not apply to an account of a foreign subsidiary, or where the U.S. person is employed by a different company than the company with the foreign account (e.g., the exception appears not to apply to the CFO of a publicly traded company who has signature authority over a foreign account of a U.S. or foreign subsidiary, but is not employed by that subsidiary).

CIRCULAR 230

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