Proskauer

newsletter

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in this issue

SEC Adopts New Short Selling Rules

On February 24, 2010, the Securities and Exchange Commission (the "SEC") adopted new short selling rules. The SEC adopted what is referred to as the "Alternative Uptick Circuit-Breaker". Under this rule, if an equity security listed on a national market declines in price 10% or more in a day, a short sale may not be executed at a price at or below the national best bid price for the rest of that trading day <u>and</u> the following trading day.

During the open meeting, Chairman Schapiro stated that the new rule will limit the potential for abusive short selling. However, Commissioners Casey and Paredes stated that there was no evidence that short selling created the market volatility of last year, and they were unsure of how the new rules would increase investor confidence.

Proposed Regulations Exempt Taxpayers from FBAR Reporting for Interests in Offshore Private Equity and Hedge Funds Until Further Guidance is Issued

On February 26, 2010, the Treasury Department published long-awaited, revised proposed regulations clarifying which taxpayers will be required to file the Report of Foreign Bank and Financial Accounts, Form TD F 90-22.1 ("FBAR"), and which accounts will be reportable.[1] In addition, the Internal Revenue Service (the "IRS") issued Notice 2010-23 (the "Notice") and Announcement 2010-16 (the "Announcement"), which are related to FBAR filings.[2]

Proposed Regulations

The proposed regulations, drafted by Treasury's Financial Crimes Enforcement Network ("FinCEN"), address some of the issues raised by the IRS in Notice 2009-62. Notice 2009-62, which was issued by the IRS on August 10, 2009, extended the FBAR filing deadline for the 2008 and earlier calendar years to June 30, 2010 for certain filers, and

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[1] A copy of the proposed regulations is available at http://www.fincen.gov.

[2] A copy of the Notice is available at http://www.irs.gov/pub/irs-drop/n-10-23.pdf and a copy of the Announcement is available at http://www.irs.gov/pub/irs-drop/a-10-16.pdf.

requested comments from the public regarding certain issues, including when an interest in a foreign entity should trigger an FBAR filing requirement. For our prior client alert regarding Notice 2009-62, click here.

Specifically, the proposed regulations add definitions of the accounts subject to reporting. The preamble to the proposed regulations notes that FinCEN has chosen to define the accounts subject to reporting (*i.e.*, bank, securities, and other financial accounts) with reference to the kinds of financial services for which a person maintains an account. Under these rules, "other financial account" is defined as:

- an account with a person that is in the business of accepting deposits as a financial agency;
- an account that is an insurance policy with a cash value or an annuity policy;
- an account with a person that acts as a broker or dealer for futures or options transactions in any commodity on or subject to the rules of a commodity exchange or association; or
- an account with a mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions.

The proposed regulations specifically reserve with respect to the treatment of investment funds other than mutual funds and similar pooled funds. **Accordingly, until further guidance is issued, there is no requirement to file an FBAR with respect to an interest in an offshore private equity fund or hedge fund.** However, the preamble to the proposed regulations notes that Treasury remains concerned about the use of, for example, hedge funds to evade taxes and FinCEN will continue to study this issue.

The proposed regulations also exempt certain persons with signature or other authority over foreign financial accounts from filing FBARs. The exceptions apply only if such persons have no financial interest in the reportable account. However, the exceptions are not as broad as commentators had requested and generally apply only to officers and employees of financial institutions that have a federal functional regulator, and certain entities that are publicly traded on a U.S. national securities exchange, or that are otherwise required to register their equity securities with the Securities and Exchange Commission.

IRS Guidance

The Notice provides three important changes and clarifications to the current rules:

1) Foreign "Commingled Funds" Do Not Include Offshore Private Equity and Hedge Funds. For purposes of FBAR filings, the IRS will not interpret the term "commingled fund" to apply to funds other than mutual funds for calendar year 2009 and prior years. For these purposes, "[a] financial interest in, or signature authority over, a foreign hedge fund or private equity fund" is specifically excluded from the term "commingled fund." Accordingly, U.S. persons holding interests in offshore private equity and hedge funds will not be required to file FBARs with respect to those funds for 2009 and prior years. U.S. persons holding interests in offshore mutual funds will still be required to file an FBAR, unless another exception applies.

2) Signature Authority but No Financial Interest. Persons with signature authority over, but no financial interest in, a foreign financial account for which an FBAR would otherwise

Compliance Reminders

- > The deadline for registered investment advisers to comply with the new SEC rules on custody is March 12, 2010. We encourage advisers to review their operations to ensure full compliance with the new rules.
- > Registered investment advisers are required to amend their Form ADV each year by filing an annual updating amendment within 90 days after the end of their fiscal year.
- > Updates of Form D, where there is an ongoing offering, are required on an annual basis on or before the anniversary of the original filing (unless an amendment is otherwise required prior to such date).
- > New Massachusetts data security regulations have gone into effect. There rules apply to advisers having Massachusetts investors. Click here to access our Client Alert, *New Massachusetts Data Security Regulations Go Into Effect on March 1, 2010*.

have been due on June 30, 2010 pursuant to Notice 2009-62 now have until June 30, 2011 to file FBARs with respect to those foreign financial accounts. This applies for the 2010 and prior calendar years.

3) FBAR Reporting on Tax Returns. If a taxpayer has no other reportable foreign financial accounts for the year in question, a taxpayer who qualifies for the filing relief provided in #1 and #2 above should check the "no" box in response to FBAR-related questions found on U.S. federal tax forms for 2009 and earlier years that ask about the existence of a financial interest in, or signature authority over, a foreign financial account.

IRS Releases Directive on Total Return Swaps Used To Avoid Dividend Withholding Tax

On January 14, 2010, the IRS issued an industry directive (the "Directive") to its field examiners providing guidance on examining total return swaps that may have been executed in order to avoid tax with respect to U.S. source dividends paid to foreign persons.[3]

Under current law, generally, the source of payments on swaps that qualify as notional principal contracts is the recipient's country of residence. Accordingly, payments on swaps to foreign persons generally are treated as foreign source payments not subject to U.S. withholding tax.

In September 2008, the Senate Permanent Subcommittee on Investigations released a report on the use of equity swaps by foreign persons to avoid withholding tax on U.S. source dividends. The IRS also has identified withholding tax compliance as a "Tier 1" issue (*i.e.*, an issue that has been designated as a top priority for IRS auditors). Pending legislative proposals would change, by statute, the sourcing of payments on total return swaps over U.S. equities as U.S. source income (and therefore, clearly subject them to U.S. withholding tax). Because these proposals are only pending, the IRS is continuing to audit existing transactions under current law.

The Directive provides guidance to recharacterize an equity swap between a U.S. financial institution and a foreign investor in order to treat the foreign investor as owning the relevant underlying equities, thereby exposing the foreign investor to dividend withholding tax liability.

The Directive focuses on four types of transactions:

1) Cross-In/Cross-Out: The first situation involves a foreign person who owns a U.S. equity security and transfers that U.S. equity security to a U.S. financial institution while, at the same time, entering into a total return swap with the financial institution that references the same security (a "cross-in"). After the dividend record date, the foreign person terminates the swap and, at the same time, reacquires the security from the U.S. financial institution (a "cross-out").

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[3] A copy of the Directive is available at http://www.irs.gov/businesses/corporations/article/0,,id=218225,00.html.

2) Cross-In/Inter-Dealer Broker Out: The second situation involves facts that are the same as the first, except that when the foreign person terminates the swap, it reacquires the security from a third party that is not an affiliate of the financial institution. In one variation, the unaffiliated third party is an inter-broker dealer.

3) Cross-In/Foreign Affiliate Out: The third situation involves facts that are the same as the first, except that the foreign person enters into the swap with a foreign affiliate of the U.S. financial institution, and the foreign affiliate enters into a back-to-back swap with the U.S. financial institution.

4) Fully Synthetic: The fourth situation involves facts that are the same as the first, except that the foreign person has never owned the U.S. security referenced by the swap, the U.S. financial institution hedges its risk under the swap, and the foreign person does not purchase the referenced security when it terminates the swap.

The Directive instructs auditors to pursue examinations of total return swaps with facts similar to Situations 1 through 3. However, absent additional exceptional facts, auditors are instructed not to pursue total return swaps similar to Situation 4.

The Directive also identifies two circumstances which appear to be of interest to the IRS: (i) swaps over privately held U.S. equities; and (ii) swaps executed using an "automated trading program" offered by a U.S. financial institution.

Hart-Scott-Rodino Filing Thresholds Reduced

The Federal Trade Commission has reduced the size thresholds governing pre-merger filings that must be made under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "Act"). The purpose of the Act is to provide both the FTC and the Department of Justice with basic information on a transaction and the parties.

Effective February 22, transactions valued above $63.4 million will require HSR filings. The previous threshold was $65.2 million. The filing thresholds for larger transactions also have been reduced. The old $130.3 million threshold has been reduced to $126.9 million, and the old $651.7 million threshold has been reduced to $634.4 million.

Update on Proposed EU Directive on Alternative Investment Fund Managers ("AIFMD")

AIFMD currently is being debated in the European Parliament and the European Council. The Parliament and Council need to reconcile their respective draft versions of AIFMD before it can become law.

In the European Parliament, Jean-Paul Gauzès, the rapporteur of the Parliament's Economic and Monetary Affairs Committee ("ECON Committee"), received 1669 amendments to the text of AIFMD from fellow Members of Parliament (MEPs) who serve on the ECON Committee. This is an unprecedented number of amendments for EU financial services legislation. Nevertheless, it appears that the proposed timetable for the consolidation and debate of these amendments remains unchanged, and Gauzès will aim to put the compromise text to a committee vote in April, followed by a plenary vote in July.

Separately, the European Parliament's Legal Affairs Committee ("JURI"), whose role is to provide the ECON Committee with an opinion, has reviewed the current text of AIFMD and issued a draft opinion on January 26. The opinion proposed a series of additional changes – for instance, it called for regulation of funds in addition to fund managers, stricter rules for private equity-backed companies that reduce the threshold for disclosure to SMEs, and a hard leverage cap of five times assets. These additional proposals are controversial and, in some cases, contrary to the sentiment expressed in the Gauzès report. Nevertheless, this opinion is a political and aspirational document, rather than a submission of amendments, and is subject to amendments by other members of JURI. It will be considered by the ECON Committee along with the 1669 amendments referred to above.

In the European Council, the new Spanish Presidency continued the negotiations process and produced a reworked text on February 3. A further revised (third) version of the compromise text was published on February 15. Although the Spanish Presidency used as their starting point the previous compromise text by the Swedish Presidency, they have reinstated Article 35 which was removed by the Swedes. Article 35 stipulates that non-EU managers and funds may only be able to access the EU market if there is a cooperation agreement in place between the jurisdiction where they are based and the EU jurisdiction in which they wish to market. In practice such agreements would be difficult to establish. They also have inserted similar conditions for EU managers who wish to market non-EU funds to professional investors in the EU market. Spain aims to agree on a compromise text among EU member states' governments in March 2010. However, this may be an ambitious target given the prevailing disagreement in the Council on a number of key issues, including the overall scope of AIFMD, depositary requirements, and the third-party regime. We also understand that signals from the Spanish Presidency indicate that an agreement on AIFMD by June 2010 is unlikely, which means that AIFMD will continue to be debated under the Belgian Presidency.

On January 21, 2010, the UK Financial Services Authority ("FSA") published a briefing which summarizes the status, purpose and key provisions of AIFMD. While the FSA expressed support for many of the aims of AIFMD, it is concerned that specific provisions may restrict investor choice and increase costs substantially. In particular, the FSA suggested that the scope of AIFMD, restrictions on delegations to non-EEA entities for management services, custody and depositary activity, and "disproportionate regulation," such as arbitrary leverage caps and portfolio company disclosure, are the biggest issues. The FSA suggested that late 2012 or mid-2013 are possible dates for the AIFMD to enter into force and be implemented.

A senior FSA official, Dan Waters, recently told a London conference that as many as 40% of the world's hedge funds will not have access to the EU under AIFMD.

UCITS Requirements and UCITS IV Proposals

The Undertaking for Collective Investment in Transferable Securities ("UCITS") directive, that was originally adopted in 1985, was created to facilitate the creation of a single European Market in retail funds. The latest update of this framework is UCITS III, which came into force in 2004.

Traditionally, UCITS have been dominated by long-only managers. Since 2007 the full implications of UCITS III have become apparent, and the UCITS space has seen UCITS offerings using hedge fund-type strategies.

UCITS III funds currently are classified either as “sophisticated” or “non-sophisticated.” Non-sophisticated funds operate as long-only funds, while sophisticated funds may invest in a broader range of asset classes, including derivatives and other strategies.

UCITS III with its more liberal investment requirements allows hedge fund managers the ability to use similar strategies and techniques within the UCITS framework, although with some important distinctions, including a prohibition against shorting. Whereas a hedge fund can physically short sell a stock, a UCITS III fund is not permitted to do so. By investing in a derivative of a particular stock, however, an asset manager of a UCITS fund can achieve the same shorting effect and comply with the rules. Other major differences include the requirement for a UCITS fund to provide twice monthly liquidity at a minimum, prohibition on leverage of more than 100% through the use of financial derivative instruments, tougher counterparty risk exposure limits and increased transparency.

UCITS IV is due to come into force across EU Member States in July 2011.

The principal features of this legislation are:

> Simplification of the procedures for cross-border distribution to minimize the ability of Member States to impose their own local registration requirements.
>
> Management company passport permitting UCITS authorized in one Member State to be managed by a management company established in another Member State. Presently, a management company can only manage a UCITS when it is domiciled in the same Member State as the fund.
>
> Replacement of the UCITS III simplified prospectus with a key investor information document designed to present information in a simplified and more uniform manner.
>
> Common rules governing UCITS fund mergers across Member States.
>
> Provisions which allow for UCITS feeder funds or master feeder structures.

Significant Developments in Placement Agent Regulation in Both New York and California

February proposals in New York and California – home to some of the nation’s largest public pension plan investors – would mark significant policy changes with respect to the use of placement agents to solicit private equity investment from public pension plans.

On February 18, New York City Comptroller John C. Liu proposed new rules that would apply to the five New York City public pension systems (the “NYC Plans”), collectively valued at $98 billion. The Comptroller’s proposal would permit fund managers to use “legitimate placement agents who provide value-added services” to solicit investments from the NYC Plans. The proposal, which must be adopted formally by the NYC Plans’ five governing boards, would loosen the current outright prohibition on the use of placement agents adopted by each NYC Plan.

A placement agent would need to meet minimum requirements to be eligible to solicit a NYC Plan, including (i) disclosure of fees paid and other engagement terms, as well as resumes of principals and key employees, (ii) proper registration with the SEC and Financial Industry Regulatory Authority (FINRA), (iii) demonstrated ability to raise at least $500M in commitments from entities other than the NYC Plans in two of the last three years, and (iv) a “full description of the value-added services” the placement agent provides.

The Comptroller’s proposal still must be adopted by the governing boards of the NYC Plans before it would take effect.

In California, Assembly Bill 1734 introduced on February 8 would subject placement agents seeking to solicit California state public pension plans to strict gift limits and campaign contribution prohibitions and require placement agents to register as lobbyists under the California Political Reform Act. Perhaps most significantly, AB 1734 would prohibit placement agents from receiving compensation contingent on any pension fund investment decision. AB 1734 has been endorsed by Rob Feckner, President of the California Public Employees’ Retirement System (CalPERS), California State Treasurer Bill Lockyer and California State Comptroller John Chiang.

If enacted, AB 1734 would apply to CalPERS (the nation’s largest public pension plan, with approximately $199 billion in assets), the California State Teacher’s Retirement System (CalSTRS) and local California jurisdictions that have lobbyist registration laws in place. Current California law signed by Governor Arnold Schwarzenegger in 2009 requires placement agents to disclose campaign contributions and gifts made to pension fund board members and requires California state and local pension plans to develop and implement policies requiring disclosure of payment to placement agents by external investment manager no later than June 30, 2010.

We are continuing to monitor development of placement regulation at the federal, state and local level. Please contact your Proskauer attorney if you have any questions about the current status of placement agent regulation in any particular US jurisdiction.

IRS Establishes Guidelines To Fix Deferred Compensation Plan Document Defects under Code Section 409A

On January 5, 2010, the IRS issued Notice 2010-6 (the “IRS Notice”), which establishes a correction program for certain inadvertent instances of documentary noncompliance involving deferred compensation arrangements subject to Section 409A of the Internal Revenue Code (“409A”). The IRS Notice also clarifies the IRS’ previously issued Notice 2008-13 regarding certain operational defects.

In addition to permitting the correction of certain specified document failures resulting in a reduction or potential elimination of current income inclusion and additional taxes under 409A, the IRS Notice also provides that certain unclear terms contained in deferred compensation plans will not be regarded automatically as a documentary failure. Finally, the IRS Notice provides transition relief for certain types of corrections until December 31, 2010, whereby certain 409A plan document failures may be corrected by December 31, 2010 without having to pay any 409A tax or penalty that would otherwise apply.

Importantly, some taxpayers may be reluctant to utilize the IRS Notice because of the information and reporting requirements that must be satisfied to achieve correction.

For additional more detailed information regarding the IRS Notice, see our previously issued Client Alert which is available here.

British Virgin Islands Court Rules on the Ranking of Redeemed Shareholders

A recent decision from the Commercial Court of the British Virgin Islands has clarified the position of a redeemed shareholder of a fund who has a claim for redemption proceeds which have become due and payable. *In the matter of Western Union International Limited v Reserve International Liquidity Fund Ltd.*, the court considered the status of a redeemed shareholder both before and after the commencement of the liquidation of a fund and the operation of Section 197 of the Insolvency Act, 2003 (the "Act"). Section 197 states that:

"A member, and a past member, of a company may not claim in the liquidation of the company for a sum due to him in his character as a member, whether by way of dividend, profits, redemption proceeds or otherwise, but such sum is to be taken into account for the purposes of the final adjustment of the rights of members and, if appropriate, past members between themselves."

In *Western Union*, the court considered when a shareholder's redemption of its shares in Reserve International was completed and when a shareholder became a creditor of Reserve International in respect of the redemption proceeds. The court concluded that the effect of Reserve International's Articles of Association was that if a redemption request was received by the fund before 5:00pm on a dealing day, the redemption of the shareholder's shares was completed upon the same day.

The court held that a member who had submitted a redemption notice and whose redemption was completed before the commencement of the liquidation was a creditor for the unpaid redemption proceeds. In such circumstances, the redeemed shareholder would rank side by side with other unsecured creditors of the fund.

The court distinguished this from the position of a member who sought to claim in a liquidation as a creditor in respect of redemption proceeds arising from a redemption which had not been completed before the liquidation commenced (i.e., where a redemption notice had been submitted but the redemption date and/or the payment date had not passed before the fund either suspended redemptions/payments or was put into liquidation). In such circumstances, Section 197 would preclude the member in question from claiming the redemption proceeds in competition with other unsecured creditors of the fund, as it would still be a member. The court's decision is under appeal.

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Our Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity and hedge funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

This newsletter for clients of our Private Investment Funds Practice discusses recent developments affecting hedge funds and private equity funds.

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