

# Private Investment Funds Update

**June 2012**

## **FBAR Reports due June 29**

A Report of Foreign Bank and Financial Accounts, Form TD-F 90-22.1 ("FBAR"), must be filed by June 29, 2012 by any U.S. person that held a financial interest in, or signature or other authority over, a foreign financial account for calendar year 2011, if the aggregate value of all the U.S. person's foreign financial accounts exceeded \$10,000 at any time during the year. The report must be received by the U.S. Department of Treasury on June 29, 2012 (not merely postmarked by that date), rather than June 30, 2012 because June 30, 2012 is a Saturday.

As described below, the ownership of an interest in a hedge or private equity fund by itself is not currently subject to FBAR reporting. However, the fund itself may have a filing obligation under certain circumstances, as well as officers and employees of the fund or of its investment manager or general partner, and an investor that owns a controlling interest in the fund. Scenarios that may trigger FBAR reporting for hedge funds or private equity funds include:

- A U.S. fund may have to file if it owns a foreign bank account.
- A U.S. feeder fund may have to file if it owns more than 50% of a foreign master fund that owns a foreign bank account.
- A U.S. fund with a controlling interest in a portfolio company may have to file with respect to the portfolio company's foreign bank accounts.
- An officer of a fund may have to file with respect to his or her signature authority over the foreign bank accounts of a portfolio company.
- An investor in a foreign feeder fund may have to file with respect to the fund's foreign securities account if it owns more than 50% of the foreign feeder.

Last year, the Financial Crimes Enforcement Network ("FinCEN") released guidance (FinCEN Notice 2011-1 and FinCEN Notice 2011-2) that provided an extension of time to file FBARs for officers and employees of certain entities who had signature authority over, but no financial interest in, certain foreign financial accounts. Pursuant to FinCEN Notice 2012-1, this deadline was extended for reports for 2011 and prior years from June 30, 2012 to June 30, 2013. Among the limited categories of individuals covered by these notices are officers and employees of investment advisers registered with the SEC with signature or other authority over the foreign financial accounts of entities that are not registered investment companies (officers and employees with signature or other authority over the foreign financial accounts of registered investment companies generally are exempt from filing the FBAR).

As described in our prior client alerts, although an interest in a hedge fund or private equity fund is not treated as a foreign financial account under the current FBAR rules, the final regulations issued by FinCEN reserve the treatment of interests in pooled investment funds such as hedge funds and private equity funds. As a result, there may be an FBAR filing requirement with respect to interests in private funds organized outside the United States in the future. Based on a prior IRS notice, any such requirement would not apply to any hedge fund or private equity fund interest held in calendar year 2009 and prior years. Interests in foreign mutual funds or similar pooled funds that issue shares to the general public and have a regular net asset value determination and a regular redemption feature are considered foreign financial accounts for FBAR purposes, and therefore should be reported.

The FBAR filing obligations are in addition to other reporting obligations that a U.S. person may have under U.S. law, including reporting obligations imposed under the Internal Revenue Code. In particular, individuals generally are required to report on IRS Form 8938 annually their interests in "specified foreign financial assets" with an aggregate value in excess of \$50,000. Specified foreign financial assets include, to the extent held for investment and not held in a financial account, foreign stock or securities, any interest in a foreign entity, and any financial instrument or contract with a foreign issuer or counterparty.

For further discussion of recent FBAR guidance, please see our client alerts dated March 14, 2011: [FinCEN Issues Final Rules on FBAR](#) and June 16, 2011: [Delayed FBAR for Signature Authority](#).

## **Investment Advisers to ERISA Plans and Plan Asset Funds Must Provide New Disclosure to Clients by July 1, 2012**

Final regulations adopted by the U.S. Department of Labor (DOL) under Section 408(b)(2) of ERISA will go into effect on July 1, 2012. Under the regulations, investment advisers must disclose certain information regarding the services they provide and the compensation they receive to:

- any ERISA-covered pension plan to which they provide services directly (such as through a separate managed account), and
- any ERISA-covered pension plan that is an investor in a private investment fund that is deemed to hold the "plan assets" of ERISA-covered pension plans.

Required disclosures include, among other things:

- a description of the services to be provided;
- a description of the direct and indirect compensation to be received and the manner in which it will be received;
- a statement as to whether the covered service provider reasonably expects to provide services as an ERISA fiduciary or a registered investment adviser; and
- for a private investment fund deemed to hold plan assets: (i) the fund's annual operating expenses (e.g., expense ratio) and any ongoing expenses in addition to annual operating expenses; and (ii) any compensation that will be charged directly against the investment (such as account fees, commissions, sales loads and redemption fees) and that is not included in the fund's annual operating expenses.

Investment advisers required to make the disclosure must promptly update changes (generally no later than 60 days from the date the adviser is informed of the change) to previously disclosed information (other than the plan asset fund investment-related information described directly above, which must be updated at least annually). Covered service providers also must furnish, upon request, any other information relating to the compensation it received that is required for the ERISA plan to comply with the reporting and disclosure requirements of ERISA (e.g., Form 5500 reporting).

The final regulations require that the disclosures be made reasonably in advance of the date that the investment advisory contract or limited partnership agreement is entered into, extended or renewed. With respect to arrangements already in existence, such disclosures must be made no later than the July 1, 2012 effective date of the final regulations. Failure to comply with the final regulations could lead to a nonexempt prohibited transaction, the penalties for which can include the imposition of excise taxes and a refund of compensation. In addition, if the requisite disclosures are not provided, the plan may, in certain cases, be required to notify the DOL of the failure and to terminate the contract or arrangement with the covered service provider.

See our prior client alerts, [Department of Labor Issues Final Regulations Requiring Fee Disclosures by Pension Plan Service Providers and Fiduciaries Managing Plan Asset Vehicles](#) and [Investment Advisers to ERISA Plans and Plan Asset Funds Will Be Subject to New Disclosure Obligations Effective July 1, 2012](#) describing these final regulations in greater detail.

### **SEC Issues Additional Guidance on Form PF**

On June 8, 2012, the SEC posted several "frequently asked questions" on its Web site providing some interpretive guidance for registered investment advisers who may have reporting obligations under Form PF. See <http://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml>. In general, the FAQs are consistent with the interpretive positions taken by the SEC staff in the adopting release for Form PF, and provide little in the way of additional relief for reporting advisers.

The FAQs reemphasize that the SEC takes a very broad view of what types of funds fall within the definition of a "hedge fund" for Form PF reporting purposes. For example:

- The FAQs provide that any private fund whose governing documents would permit the fund to "either employ large amounts of leverage or sell assets short" must be treated as a hedge fund for Form PF reporting purposes, even if the fund does not engage in such activities and has no intention of doing so. Note, however, that according to the Adopting Release for Form PF, the failure of a fund's governing documents to specifically prohibit leverage or short selling activities does not automatically mean that the fund must be treated as a hedge fund under Form PF, so long as the fund does not actually engage in such activities, and a reasonable investor would understand that, based on the fund's offering documents, the fund will not engage in such activities.

- The FAQs also provide that if a fund that previously has been reporting under Form PF as a non-hedge fund acquires one of the defining characteristics of a hedge fund (e.g., by amending the fund's governing documents to permit the fund to engage in short sales), it must begin reporting under Form PF as a hedge fund.
- A fund that meets the defining characteristics of both a liquidity fund and a hedge fund must report as *both* a hedge fund and a liquidity fund. In other words, the definitions of a hedge fund and a liquidity fund are not mutually exclusive.

The FAQs provide that, even though commodity pools must generally be treated as hedge funds for Form PF reporting purposes, a fund whose commodity interest positions satisfy the *de minimis* tests in CFTC Rule 4.13(a)(3)(ii) need not report as a hedge fund, so long as the fund does not otherwise fit within any of the other defining characteristics of a hedge fund.

Other FAQs provide additional guidance on how assets under management should be aggregated, and on how fund-of-fund assets should be treated, for Form PF reporting purposes.

### **Hong Kong Short Position Reporting Regime: Identity of Partners in Partnership Need Not Be Disclosed**

A new Short Position Reporting Regime came into effect in Hong Kong on June 18, 2012, as previously reported in our advisory, [New Short Position Reporting Regime in Hong Kong](#). The first day for which a report must be filed with the Securities and Futures Commission (SFC) was Friday, June 22, 2012, and the deadline for filing the first report was midnight (Hong Kong time) on Tuesday, June 26, 2012.

One of the requirements of the new regime that directly concerns partnerships is the obligation to file with the SFC the particulars of all of the partners in a partnership in a prescribed format. However, the SFC has issued informal advice relaxing this requirement and requiring only that the particulars of the partnership and the general partner be filed.

This is a positive development for partnerships, as the SFC has recognized the difficulties that partnerships face with reporting information about their limited partners. However, the SFC reserved the right to call for the full information from partnerships in the future.

### **CFTC and SEC Define "Swap Dealer" and "Major Swap Participant"**

The U.S. Commodity Futures Trading Commission (CFTC) and the SEC, in consultation with the Board of Governors of the Federal Reserve System, recently adopted new rules defining "swap dealer" and "major swap participant" required to register under the Dodd-Frank Act. Fortunately for most managers of private funds, the thresholds triggering registration were set relatively high.

The CFTC and the SEC still have not yet issued the final rules defining which swaps are subject to their respective jurisdictions, which will ultimately determine whether many advisers to private funds will need to register with the CFTC as a commodity pool operator (CPO) or commodity trading advisor (CTA). The CFTC has jurisdiction over "swaps" and the SEC has jurisdiction over "security-based swaps."

### **Definition of "Swap Dealer"**

The final definition of the term "swap dealer" closely follows the Dodd-Frank statutory text. The final rule defines the term "swap dealer" as a person which:

- holds itself out as a dealer in swaps,
- makes a market in swaps,
- regularly enters into swaps with counterparties as an ordinary course of business for its own account, or
- engages in activity causing itself to be commonly known in the trade as a dealer or market maker in swaps.

According to interpretive guidance issued by the SEC and CFTC, a person who "makes a market in swaps" routinely stands ready to enter into swaps at the request or demand of a counterparty. The CFTC and SEC provided examples of activities that are part of a "regular business" and, therefore, are indicative of swap dealing. These examples include entering into swaps to satisfy the business and risk management needs of a counterparty, recording a separate profit and loss statement for swap activity, and allocating staff and resources to dealer-type activity.

The interpretive guidance provides for various exceptions to the definition of a "swap dealer," including:

- An insured depository institution to the extent it offers to enter into certain swaps with a customer in connection with originating a loan for that customer.

- A person entering into certain hedging swaps for the purpose of offsetting or mitigating price risk arising from the potential change in the value of assets that the person owns, produces, manufactures, processes or merchandises, liabilities that the person owns or anticipates incurring, or services that the person provides or purchases, if the swap represents a substitute for transactions or positions in a physical marketing channel.
- A person entering into swaps only with certain affiliates.
- A person who does not enter into swaps over a 12-month period that have an aggregate gross notional amount exceeding \$3 billion (or \$150 million in the case of certain security-based swaps, other than credit default swaps). The aggregate gross notional amount of such swaps with certain "special entities" (including certain governmental and other entities) over the prior 12 months must not exceed \$25 million.

### **Definition of "Major Swap Participant"**

- The Dodd-Frank Act defines a "major swap participant" as:
- a person who maintains a "substantial position" in any of the major swap categories, excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan;
- a person whose outstanding swaps create "substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets"; or
- any "financial entity" that is "highly leveraged relative to the amount of capital such entity holds and that is not subject to capital requirements established by an appropriate Federal banking agency" and that maintains a "substantial position" in any of the major swap categories.

The statutory definition excludes swap dealers and certain financing affiliates.

The CFTC and SEC clarified several key terms in the definition of "major swap participant."

- A "substantial position" is defined in part as current uncollateralized exposure, on a net basis, of at least \$1 billion in a major swap category other than rate swaps, or \$3 billion for rate swaps. Under a second test, a "substantial position" also may exist if the total notional principal amount of all swap positions held by a person, multiplied by specified risk factor percentages (ranging from 0.5% to 15%) based on the type of swap and the duration of the position, and subject to various

discounts, exceed \$2 billion in a major swap category other than rate swaps, or \$6 billion for rate swaps.

- "Substantial counterparty exposure" is defined generally as aggregate swap positions (across all swap categories) equal to at least \$5 billion of current uncollateralized exposure, or \$8 billion of current uncollateralized exposure plus potential future exposure.
- "Financial entity" is defined to include private funds, and "highly leveraged" is defined as a ratio of total liabilities to equity, as determined in accordance with U.S. GAAP, of at least 12 to 1.

## **BEA Amends Reporting Obligations**

Effective May 24, 2012, the U.S. Bureau of Economic Analysis (the "BEA"), an agency of the U.S. Department of Commerce, adopted a final rule regarding its surveys on international trade in services and on direct investments. Under the new rule, only persons receiving notice from the BEA with respect to a particular survey will be required to prepare and submit the survey.

The BEA is responsible for generating economic account statistics, including levels of "direct investment" in the United States and abroad. The BEA relies on a system of surveys in order to gather the data to prepare these accounts. Historically, U.S. persons and entities have been required to submit these surveys if their economic activities met the threshold level indicated in the instructions of each survey. The new rule will streamline the procedure so that only those U.S. persons or entities notified of a survey by the BEA will be required to submit that survey.

The surveys most applicable to U.S. asset managers, including the surveys of "direct investment" outside the United States, are covered by the new rule. However, the new rule does not contain any transitional provisions, so it is unclear whether U.S. persons must still follow the old requirements with respect to surveys that were published by the BEA prior to May 24 but that are due after that date (or surveys with respect to periods that ended prior to May 24 that are due following such date). If you have any questions regarding BEA surveys, you should contact your Proskauer lawyer.

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#### Related Professionals

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- **Arnold P. May**  
Partner
- **Amanda H. Nussbaum**  
Partner
- **Scott S. Jones**  
Partner
- **Charles (Chip) Parsons**  
Partner
- **Jamiel E. Poindexter**  
Partner
- **Marc A. Persily**  
Partner
- **Ira G. Bogner**  
Managing Partner
- **Sarah K. Cherry**  
Partner
- **Bruce L. Lieb**
- **Nigel van Zyl**  
Partner
- **Mary B. Kuusisto**  
Partner
- **David W. Tegeler**
- **Howard J. Beber**

Partner

- **Robin A. Painter**
- **Christopher M. Wells**
- **Stephen T. Mears**

Partner