REGULATORY UPDATE FOR ALTERNATIVE INVESTMENT FUNDS

Spring 2014

As the regulatory landscape for alternative investment managers continues to evolve, managers are being asked to dedicate more time and attention to matters of regulatory compliance. These summaries highlight the latest regulatory developments across several key initiatives, to help you stay informed about regulatory change that may affect operations and, where applicable, to consider how they can work with your administrators to meet these requirements.

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ALTERNATIVE INVESTMENT FUND MANAGERS DIRECTIVE (AIFMD)

This Regulation Affects

- Non-UCITS funds managed in, domiciled in, and/or distributed in the European Union
- Non-EU managers wishing to sell in Europe

Key Takeaways

- New operational requirements have been established around depositaries, valuation, reporting and distribution
- Managers need to demonstrate compliance with the new requirements

Overview

The one-year transition period for the Alternative Investment Fund Managers Directive (AIFMD) implementation is continuing throughout Europe. All affected entities have until July 22, 2014, to become AIFMD compliant and apply for authorization from their national regulators.

Key Impacts

As of March 2014, 16 of the 28 countries in the European Union had transposed the AIFMD regulations into national law. All key fund centers (Luxembourg, Ireland and the United Kingdom) have completed this process. Various regulatory bodies in the key EU fund jurisdictions are issuing regular guidance and consultation papers detailing how their national, transitional and supervisory regimes will operate. With respect to third countries (non-EU countries), Guernsey is seeking to provide an AIFMD-equivalent jurisdiction for managers wishing to market in Europe. Guernsey's AIFMD-equivalent rules came into force on January 2, 2014, for managers that wish to opt in, but the previous regulatory regime still applies for those managers that do not wish to be based in, or market to countries based in, the European Economic Area.

Next Steps

Alternative Investment Fund Managers, including hedge funds, are in the process of preparing their applications for authorization from their national regulators. We expect to see a large number of our hedge fund clients apply for authorization before the end of first quarter 2014. About 100 managers have been authorized to date across the EU. The Financial Conduct Authority (FCA) in the United Kingdom will accept applications up until the July 22, 2014, deadline. It appears that the Central Bank of Ireland will also accept applications until the July 22 deadline, although we are awaiting further clarity from the regulator.

How Your Administrator Can Help

Fund administrators carry out activities that support the actual process of running a fund, including calculation of performance, preparation of reports and prospectuses, settlement of purchases, and monitoring compliance with regulation. Your administrator may offer AIFMD reporting services, such as data provision in which they provide data from their systems in the required AIFMD format. If your administrator is bank-affiliated, they may also be able to provide a range of Depositary services that will help to meet that aspect of the Directive.

FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

This Regulation Affects

- U.S. and foreign managed funds, including hedge funds, venture capital funds, private equity funds, and funds of funds that invest in non-U.S. funds or make payments to foreign financial institutions (FFIs)
- Foreign financial institutions (FFIs) including non-U.S. banks, brokers, custodians, investment funds and insurance companies

Key Takeaways

- U.S. pension and retirement plans making payments to non-U.S. entity investors will need to determine whether withholding tax is necessary based on FATCA requirements, and will need to withhold payments when the required information is not provided.
- To ensure inclusion in the U.S. Internal Revenue Service FFI list, financial institutions will need to finalize their registrations by April 25, 2014.
- FATCA requirements are being phased in beginning with a July 1, 2014, deadline for new account documentation procedures and certain withholding taxes.

Overview

Under the Foreign Account Tax Compliance Act (FATCA), financial institutions worldwide, including banks, brokers and traditional and alternative investment funds, will be required to report information about financial accounts held by U.S. taxpayers to the U.S. Internal Revenue Service (IRS).

On February 20, 2014, the IRS and the U.S. Treasury Department (Treasury) issued revised FATCA regulations as well as additional regulations that coordinate the FATCA requirements with other existing U.S. tax reporting and withholding rules.

A few initial observations include:

- The revised regulations do not further delay the effective date of FATCA, which remains July 1, 2014;
- The effective date of the conforming regulations is also generally July 1, 2014, leaving U.S. withholding agents little time to modify their new client onboarding processes;
- Portions of the revised FATCA regulations and the coordinating regulations have been issued in temporary form, while others have been issued in final form; and
- It appears there will be a comment period.

Key Impacts

IRS Online Registration

The IRS online registration system was launched in August 2013. Alternative investment funds that must register with the IRS to meet their FATCA obligations should begin registering by creating an account and providing required information. These financial institutions will then receive a notice of registration acceptance and will be issued a Global Intermediary Identification Number.

The IRS will electronically publish its first FFI list in June 2014 and will update the list monthly. To ensure inclusion in the June 2014 IRS FFI list, financial institutions must finalize their registrations by April 25, 2014.

Intergovernmental Agreements

More than 20 countries have entered into intergovernmental agreements (IGAs) with the United States to implement FATCA, and the number continues to grow. Most recently, on February 5, 2014, the Canada Department of Finance announced that Canada and the United States have signed an IGA under the longstanding tax convention between the countries. The IGA allows for financial institutions in Canada to report information to the Canada Revenue Agency, which will then exchange the information with the IRS. Pension plans that currently qualify for a zero rate of withholding on U.S. dividends pursuant to the United States – Canada income tax treaty will also be exempt from FATCA withholding as exempt beneficial owners under the IGA.

U.K. Bilateral Agreements With the Crown Dependencies and Overseas Territories

In October and November 2013, agreements were made between the United Kingdom and the countries of the Crown Dependencies and Overseas Territories (CDOT). This includes the Isle of Man, Guernsey, Jersey, Gibraltar, the Cayman Islands, Bermuda, Montserrat, Turks and Caicos, and British Virgin Islands. Due to the similarity with U.S. FATCA, these agreements are commonly known as “Son of FATCA.” Many uncertainties remain, making it difficult for financial institutions to fully implement operational and systems changes. On January 31, 2014, Jersey, Guernsey and the Isle of Man jointly issued draft guidance notes on the implementation of their IGAs with the United States and the United Kingdom.

FATCA Requirements for U.S. Institutions Making Payments to Non-U.S. Payees
Under the new FATCA regime, U.S. payors (including alternative investment funds) will first have to consider whether they are making a FATCA "withholdable payment," and then whether the payee is FATCA-compliant. If the payee is compliant, the payor must then refer to existing non-resident alien (NRA) rules to determine whether NRA withholding applies, or if a treaty claim might reduce or eliminate the withholding. FATCA withholdable payments, which generally include financial-type payments such as investment advisory fees, custodial fees and bank and brokerage fees, *are* subject to FATCA withholding. U.S. institutions that invest in non-U.S. investment funds will want to verify that these funds are compliant and therefore not subject to FATCA withholding.

How Your Administrator Can Help
The amount of data and record keeping involved for alternative investment funds in meeting these requirements requires advanced technology systems. Your administrator should be able to provide support in due diligence, both of pre-existing investors and clearing counterparties, and by providing ongoing monitoring; withholding; and reporting.

THE VOLCKER RULE

This Regulation Affects
- Hedge funds, private equity funds, and banking entities and non-bank financial companies supervised by the U.S. Federal Reserve.

Key Takeaway
- Asset managers including hedge funds and private equity funds must develop compliance programs that demonstrate compliance.

Overview
The Volcker Rule is part of the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act, passed in 2010 in response to the financial crisis that began two years earlier. The brainchild of Paul Volcker, chairman of the U.S. Federal Reserve from 1979 to 1987, this regulation restricts alternative investment funds and other banking entities from engaging in short-term proprietary trading for their own accounts. It also prohibits banks from owning or investing in certain private funds. The purpose of the rule is to reduce risky investing by banks in order to prevent future taxpayer bailouts.

The final rule was approved by five U.S. regulatory agencies on December 10, 2013, effective April 1, 2014. Entities must be in compliance by July 21, 2015.

Key Impacts
The proprietary trading ban affects nearly all hedge funds as it covers a range of financial instruments, including securities, derivatives contracts and options, although exceptions are made for several categories of trades.

Types of trades prohibited as principal for its trading account:

- Securities
- Options on securities
- Derivatives
- Swaps and security-based swaps
- Physical commodity forwards
- Foreign exchange swaps
- Foreign exchange forwards
- Retail foreign exchange
- Retail commodity transactions
- An option on any of the above

Categories of trades that are permitted under the Volcker Rule:

- Client transactions
- Trades conducted for market-making
- Risk-mitigating hedging
- Underwriting
- Repos
- Reverse repos
- Securities lending
- Retail commodity transactions
- Trading in U.S. government obligations and some foreign government obligations

Banks are also prohibited from sponsoring, acquiring or retaining as principal, directly or indirectly, any ownership interest in a covered fund (including hedge funds, private equity funds) as described in section 3(c)(1) or 3(c)(7) of the Investment Company Act, that, if offered in the United States, would be required to rely on section 3(c)(1) or 3(c)(7) exemptions from the definition of an investment company.

EUROPEAN COURT OF JUSTICE RULINGS

This Regulation Affects

- Asset managers, including hedge funds

Key Takeaway

- Due to an extension of the normal statute of limitations in France, clients can file claims until the end of 2014 with respect to tax deducted on French income paid in 2009 through 2012.

Overview

For nearly a decade, entities domiciled in the European Union that paid higher tax rates than equivalent entities have been able to seek lower tax rates based on legislation stating that equivalent entities are entitled to equivalent tax treatment, no matter where they are domiciled. The legislation on which these claims are based, which dates back to the formation of the EU in 1993, refers to the “free movement of capital within the EU” and sets out that equivalent entities should receive the same tax treatment – and specifically states that third-country (non-EU) entities should not suffer tax discrimination.

Now, non-EU entities are seeking the same treatment, encouraged by legal precedents in cases brought before the European Court of Justice (ECJ).

The trend towards filing tax discrimination claims has been growing for both EU and non-EU (third country) based entities, with success rates varying by market and entity. Third country entities are filing tax discrimination claims based on the premise that the legislation extends to many eligible third country investors, including those based in the United States and Canada.

The key precedent for this belief is the May 2012 *Santander* case, which included two U.S. mutual funds as litigants and held that French withholding tax levied on dividend payments by French-resident companies to non-resident investment vehicles was not compatible with EU law. Advisory firms highlight the case as evidence that the European Union holds non-EU investors in the same light as those based in the European Union.

Key Impacts

An increasing number of investors domiciled outside of the European Union are filing EU tax discrimination claims.

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