Hedge Fund Market and Regulatory Trends Update

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Trends in Hedge Fund Terms

Market Trends

- Since the March 2009 low the stock market has recovered at a rapid pace (Dow up to over 10,700 from a 2009 low of about 6,550)
- Industry wide hedge fund returns in 2009 were 20.1% - the strongest year since 1999*
  - Q1 2010 performance brings hedge fund industry within 2% of previous HWM reached in October 2007*
  - Q1 inflows of $13.7 billion of new capital*
- For the first time since the fallout from the Lehman bankruptcy in late 2008 tipped about 2,000 hedge funds into liquidation, the number of new hedge funds in the market in Q3 2009 (224) has surpassed the number of liquidations (190)
- New funds in certain spaces – e.g., credit opportunities, commodities; many problems have been worked through – firms looking to future growth of AUM

* Hedge Fund Research, Inc.

Market Trends (Continued)

- Compensation Terms
- Lockups and Redemptions
- Gates
- Side Pockets
- Increased Investor Diligence
- Existing Funds and Evolving Terms

Compensation Terms

- Crisis caused pressure on management fees (historically 1.5 – 2.0%) and, to a lesser extent, on incentive compensation (historically 20%)
  - At Y-E 2009, average was 1.6% and 19.2%*
  - Incentive compensation has trended even lower for funds of funds: 6.9%, in contrast to an average of 10% in prior years**
- Fundraising pressure, and the concurrent pressure to offer lower fees, seems to have lifted for larger managers recently, although not for smaller managers
  - Q1 inflows were focused on firms with greater than $5 bn AUM (5.1% of all funds), which received $14.9 bn in inflows*
  - This is in contrast to firms managing between $500 mm and $5 bn, which experienced $3.7 bn in outflows*

* Hedge Fund Research, Inc.
** Eurekahedge Pte. Ltd.

Compensation Terms (Continued)

- Historical performance fee structures have been scrutinized by institutional investors because many paid significant performance fees in prior years despite negative returns on an aggregate multi-year basis
  - This has led to demands — especially in managed account type structures — for multi-year performance measurement periods, clawbacks and similar features
- Many funds are still underwater
  - Estimates vary, however (between 31%* and 47.8%**)
  - However, a number of these managers are closing in on their prior highs

* Deutsche Bank, 2010 Alternative Investment Survey (the "DB 2010 Survey") (the above survey findings were based on the individual investment performance of responding investors)

** Hedge Fund Research, Inc. (the above survey findings were based on reported fund-level NAVs)

Compensation Terms (Continued)

- Recent modifications to performance compensation structures include:
  - Hurdle or preferred return over a benchmark (fixed or index-based)
  - Modified (a.k.a. "Lone Pine") HWM
  - Multi-year performance measurement period (less common in commingled funds)
- Most performance allocation structures involving multi-year measurement periods or clawbacks raise tax considerations

Lockups and Redemptions

- Generally investors are demanding shorter lockup periods, but some — especially institutional investors with longer investment horizons — are willing to accept longer lockup periods for lower fees
  - By some estimates, almost 60% of investors would be unwilling to lockup capital for more than one year*
  - Longer lockups appear to be more tolerable among U.S. investors than non-U.S. investors*
  - Investors with strong liquidity needs, such as funds of funds and family offices, also seem to be willing to accept a “soft” lockup (i.e. subject to a redemption fee) where a “hard” lockup would be unacceptable*
- The overwhelming investor preference, by a more than 2 to 1 margin, is for quarterly or monthly redemption after lockup period*
  - Assuming that the underlying investment program can support it

* DB 2010 Survey

Lockups and Redemptions (Continued)

- However some institutional investors are seeking, or are more tolerant of, longer lockup periods for funds with long-term investment theses
  - For example, certain distressed debt funds, other credit funds, event driven funds and activist funds
  - This deters early redemptions that may be harmful to the overall fund
- Thus, funds' redemption terms continue to vary across the industry, depending on investment program and targeted investor base

Gates

- During the crisis many funds put up gates and pressure is now to remove gates or apply them at a higher threshold level (e.g., 25% or more as opposed to 25% or less pre-crisis)
- Funds that actually invoked gates during the crisis have found that this has had a negative, although not fatal, impact on fundraising
  - Approximately one-third of investors expressing a reluctance to invest such funds*

* DB 2010 Survey

Gates (Continued)

- Most gates were "first come, first serve," which created a classic prisoner's dilemma
  - Skewed the incentive for investors to put redemption requests in at the first sign of trouble to maintain a higher priority over later redeemers
- More funds than in previous years have moved to apply gates at the investor level (i.e., on an investor by investor basis)
  - Mitigates prisoner's dilemma
  - But, this is less popular with smaller investors, who might not otherwise be gated if the gate were to be applied at the fund level
- Other new and creative structures are emerging to avoid skewed incentives and encourage investors not to redeem quickly
  - Fund-level gates with early and later redeemers receiving equal priority
  - Soft investor-level gates with redemption fees

Side Pockets

- Generally harder to include in newly-launching funds unless justified by investment program
- Most new funds that include side pockets are limited to 15% or less of NAV at time of investment, as compared to higher average levels pre-crisis (20% to 25%)
- A minority of funds that are permitted to use side pockets offer investors the ability to opt out (similar to fund terms at the advent of side pockets)
  - However, can raise issues: e.g., does the opt-out apply to all side pocketed investments, including investments that are side pocketed as a result of an impairment?

Side Pockets (Continued)

- Institutional investors generally recognize that side pockets are appropriate in certain cases, but are stressing:
  - Clearly stated and consistently applied side pocket policy (including how fees and HWM are calculated and types of investments eligible to be side pocketed)
  - More specific mechanics for side pockets in partnership agreements

Increased Investor Diligence

- Investors are more cautious due to Madoff-driven concerns and poor performance in recent periods
- Investors are conducting more diligence on hedge fund managers prior to investing, including:
  - Scrutinizing prior performance (including the generation of positive alpha)
  - Reviewing prior use of gates, history of suspending redemptions and liquidation of prior funds (in order to reset HWM)
  - Requiring managers to respond more frequently to detailed due diligence questionnaires
  - Hiring outside counsel to review (and in some cases negotiate) fund documents
  - Hiring outside investment consultants to assist in background due diligence

Increased Investor Diligence (Continued)

- Investors also placing greater emphasis on reputable third-party service providers, including:
  - Auditors
  - Administrators
  - Custodians
  - Prime brokers
  - Outside attorneys
  - Independent directors (for offshore or master funds in corporate form)

Existing Funds and Evolving Terms

- Some existing funds seeking to raise new capital have structured fund terms to be more investor-friendly by:
  - Reducing management fees (or waiving management fees during NAV suspensions)
  - Reducing performance compensation or subjecting it to a hurdle
  - Reducing lockup periods and providing for more frequent redemptions
  - Eliminating or limiting gates and side pockets; or
  - Limiting ability of managers to distribute securities in kind
- Other funds have allowed locked up investors to transfer fund interests in the secondary market
- Some managers have launched new funds with investor favorable terms and allowed existing locked up investors in affiliated funds to move to the new funds
- More and more managers are agreeing to manage institutional investors' money on a separate account basis as opposed to a pooled vehicle — but will this continue?

Regulatory Developments for Hedge Fund Managers

Introduction

- Numerous recent proposed and adopted regulatory changes affecting hedge funds and hedge fund sponsors, including:
  1. Proposed Investment Advisers Act registration for hedge fund managers and EU Alternative Investment Fund Managers Directive
  2. Potential changes to hedge fund private offerings
     - Inflation adjusting Reg D individual accredited investor standards (Senate Bill) or "qualified client" financial test for performance fees (House Bill)
     - Changes to state "blue sky" preemption procedures
  3. Proposed "Volcker Rule" would require banks and bank affiliates to potentially spin out hedge funds advised or sponsored by such firms
  4. Proposed SEC "Pay to Play" restrictions on state and local campaign contributions
  5. Custody rule changes for registered advisers
  6. Proposed derivatives reforms

1. Proposed Investment Adviser Registration for Hedge Fund Managers

- Within the next year, most hedge fund managers with greater than $100-150M AUM expected to be subject to Investment Advisers Act registration with the SEC, with potential additional state requirements applicable to smaller advisers
- Two Proposals
  - House and Senate have proposed separate versions of financial services reform regulation, House in December and Senate in March
  - Senate recently began floor action and may have final bill by end of May

Proposed Adviser Registration Legislation

- House Bill: Private Fund Investment Advisers Registration Act of 2009
  - Eliminates fewer-than-fifteen-client exemption for investment managers with $25M or more AUM
  - But adds new exemptions:
    1. limited "foreign private adviser" exemption if:
       - No place of business in U.S.,
       - < 15 clients or investors in U.S. in 12-month period, and
       - < $25M AUM attributable to clients or investors in U.S.
       - Not available if foreign private adviser "holds out" as IA in U.S. or advises registered funds/BDCs

Proposed Adviser Registration Legislation (continued)

- House Bill: Private Fund Investment Advisers Registration Act of 2009 (continued)
  - New exemptions:
    2. "mid-sized" private fund adviser exemption if:
       - <$150M AUM for funds relying on §3(c)(1) or §3(c)(7) exemption from 1940 Act registration*
         - » e.g., hedge, private equity, venture capital and certain real estate funds, as well as co-investment and similar vehicles
       - Adviser solely manages private funds, not managed accounts
       - SEC may establish recordkeeping and reporting obligations and new examination procedures for private funds advised by such advisers
    3. "venture capital fund" advisers (as defined by SEC)

* §3(c)(1) exempts from registration a privately-offered fund with 100 or fewer investors (counts only U.S. investors for non-U.S. fund), and §3(c)(7) exempts from registration a privately-offered fund with solely "qualified purchasers" (tests only U.S. investors for non-U.S. fund)

Proposed Adviser Registration Legislation (continued)

- House Legislation: Private Fund Investment Advisers Registration Act of 2009 (continued)
  - New recordkeeping requirements and reporting to SEC of information for "private fund"* advised by an IA, including:
    - AUM
    - Use of leverage (including off-balance sheet)
    - Counterparty credit risk exposures
    - Trading and investment positions
    - Trading practices
    - Other information SEC in conjunction with Federal Reserve determines appropriate to assess systemic risk

* Defined as any §3(c)(1) or §3(c)(7) fund

Proposed Adviser Registration Legislation (continued)

- House Bill: Private Fund Investment Advisers Registration Act of 2009 (continued)
  - New disclosure requirements and reporting to investors, prospective investors, counterparties and creditors of information for any "private fund" advised by an IA:
    - including information necessary or appropriate in public interest for protection of investors or to assess systemic risk (information and report content to be defined by SEC and Federal Reserve)
    - but not including proprietary information, sensitive non-public information regarding investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property

Proposed Adviser Registration Legislation (continued)

- Senate Bill: Restoring American Financial Stability Act of 2010
  - Reported out of Senate Banking Committee March 16, 2010
    - 400 amendments reserved for floor debate
  - Eliminates "fewer-than-fifteen-client" exemption
  - Exemptions for foreign private advisers and venture capital fund advisers similar to House proposal, adds new exemptions for private equity fund advisers and family offices (each to be defined by SEC)
  - Reporting requirements for RIA-sponsored private funds similar to House proposal, with additional reporting requirements for private equity funds to be determined by SEC within six months of Bill passage
  - Raises SEC registration threshold to AUM $100M; advisers with lower AUM to be regulated by states
  - Requires GAO feasibility study for private funds SRO

Proposed Adviser Registration Legislation (continued)

- Comparison of House and Senate Proposals

Term	House Bill	Senate Bill
Client Type Exemption	"Venture capital funds" (to be defined by SEC) and private funds with < $150M AUM	"Private equity funds" and "venture capital funds" (each to be defined by SEC)
Foreign Private Adviser Exemption	Yes	Yes
AUM Threshold for SEC Registration	>$25M AUM; ≥$150M AUM for advisers solely to private funds, states to regulate advisers with less	≥$100M AUM, states to regulate advisers with less
Inflation Adjustment of Investor Sophistication Tests	Qualified client standard	Accredited investor standard for individuals (at passage and every 5 years thereafter)
"Volcker Rule" Restrictions on Banks and Affiliates	No	Yes
Change to Regulation D Uniform State Filing Rules	No	Yes
Private Fund Reporting Requirements	Confidential disclosure of information needed to assess systemic risk	Similar proposal for RIA-sponsored private funds, with additional private equity fund reporting as required by SEC
Private Fund Disclosure Requirements	Disclosure to investors, counterparties and creditors non-private info required to assess systemic risk or in public interest	No equivalent proposal

Proposed EU Alternative Investment Fund Managers Directive

- Sweeping proposed legislation would require managers with a threshold AUM to register and receive authorization prior to carrying out fund management activities in the European Union
  - Will affect funds managed by both E.U. and non-E.U. managers
  - Restricts marketing activities, requires additional compliance steps for non-E.U. managers:
    - transparency and disclosure rules, including Directive-compliant annual reports to investors
    - additional PPM disclosures
    - annual reporting to the national regulator in each marketed E.U. jurisdiction
    - may impose independent valuation and custody, minimum capital requirements
- Treasury's Geithner issued warning to E.U. members in early April
  - claimed discrimination against U.S. funds and managers
  - noted no equivalent restrictions on E.U. managers seeking investors in the U.S.
- Directive to become effective only if agreed by European Parliament and the Council of the European Union
  - undergoing multiple revisions in 2010, no definitive timeline for passage

2. Potential Changes to Hedge Fund Private Offerings

- House Bill
  - “Qualified client” standard (restricting RIA performance-based fees to certain investors) to be indexed for inflation
    - assets under management requirement would increase from $750,000 to approx. $1M
    - net worth standard would increase from $1.5M to approx. $2M
- Senate Bill
  - “Accredited investor” standard for individual investors to be indexed for inflation and updated every five years
    - investor net worth requirement would increase from $1M to approx. $2.25M
    - investor net income requirement would increase from $200,000 (single) and $300,000 (married) to approx. $449,000 (single) and $674,000 (married)
    - estimated 70% reduction in individual AIs
  - Changes Reg D’s uniform state filing procedures, potentially subjecting private funds to substantially greater state information / filing obligations

3. Proposed “Volcker Rule”

- Senate Bill
  - Would restrict banks, insured depository institutions, BHCs and their subsidiaries from:
    - proprietary trading (i.e., trading for their own account)
    - owning, sponsoring or investing in private funds
      - restricts serving as the general partner, managing member or trustee of a hedge fund or private equity fund (or using a common or similar name / brand as bank or BHC), although non-sponsoring advisory relationship may be allowed
    - entering into certain relationships (e.g., custodial, brokerage or securities lending relationships) or non-arm’s-length transactions with private funds advised by such bank entities
  - Timing: minimum 2-year implementation, with contemplated 1-year extension period

4. Proposed Pay to Play Restrictions

- Proposed SEC Rule Prohibiting "Pay to Play" Practices
  - Both registered and unregistered IAs would be prohibited from:
    - Receiving compensation for advisory services to a "government entity" for two years after the adviser or any of its "covered associates" makes a political contribution to certain elected officials or candidates with power to influence the award of advisory business;
      - If prohibition triggered, advisers may to provide advisory services for no compensation for reasonable transition period in order to avoid penalty
      - Two-year lookback covers contributions by covered associates made at prior firms
      - Adviser to certain funds in which a government entity invests or is solicited to invest treated as if adviser were providing advisory services directly to the government entity
      - $250 de minimis exception and limited relief for certain returned contributions
    - Proposed rule prohibited paying third parties (e.g., third-party placement agents, finders or solicitors) to solicit advisory business from a government entity; subsequently, SEC and FINRA determined that FINRA would adopt rules for such placement agents; and
    - Soliciting or coordinating, directly or through a covered associate, (a) contributions for an official of a government entity to which the adviser is seeking to provide investment advisory services or (b) payments to a political party of a state or locality where the adviser is providing or seeking to provide investment advisory services to a government entity

5. Revised Custody Rule

- Change to Advisers Act Custody Rule (effective March 2010)
  - Advisers Act Custody Rule now requires RIAs with custody to take new compliance steps
    - RIAs to private funds complying with Custody Rule through GAAP audit must:
      - obtain an additional GAAP audit upon fund liquidation
      - undergo a surprise examination of client assets by an independent auditor
        - » not applicable to private fund advisers whose funds are audited annually by accountants registered with Public Company Accounting Oversight Board
        - » not applicable to RIAs with custody solely by virtue of authority to deduct fees from client account
    - RIAs complying with Custody Rule through quarterly reports must:
      - reasonably believe qualified custodian is sending such reports directly to investors
      - instruct clients to compare RIA's account statements to custodian's statements
      - requires annual surprise inspection by audit firm and SEC filing
  - If RIA has physical custody of client assets, either directly or through affiliated custodian, must obtain a SAS-70 report of custodian relating to safekeeping of client assets
  - Recent SEC guidance requires Custody Rule compliance even where RIA is not taking fees from the fund (e.g., employee funds and co-invest vehicles)

6. Proposed Derivatives Legislation

- House Bill: Derivative Markets Transparency and Accountability Act of 2009
  - Clarifies jurisdictional authority of SEC and CFTC over investment instruments and swaps, provides procedure to settle jurisdictional disputes
  - Increased regulation of swap participants
    - Confidential recordkeeping and reporting of every swap to applicable regulator
    - SEC and CFTC to publish aggregate data on positions
    - Antifraud and anti-manipulation rules of applicable regulators apply to swaps and participants
  - Increased regulation of dealers and "major swap participants" ("MSPs")
    - Procedures for determination of MSP status not well-defined
    - New registration requirement with federal bank regulators (for banks) and CFTC (for others)
    - Increased capital and margin requirements
    - New rules covering safety and soundness, market integrity and sales practices
    - Upon end-user request, swap dealers required to segregate collateral at an independent third-party custodian

Proposed Derivatives Legislation

- House Bill: Derivative Markets Transparency and Accountability Act of 2009 (continued)
  - Increased regulation of derivatives contracts
    - Central clearing required where:
      - » a regulated clearing organization (e.g., a securities or futures exchange) and applicable regulator determine that a type of contract should be accepted for clearing and required to be cleared and
      - » parties to the contract are dealers and/or major swap participants (e.g., not end-users)
    - Exchange trading required where:
      - contract is required to be cleared or
      - any exchange or swap execution facility lists the contract for trading
    - Clearing or exchange trading may be elected by end users, like hedge funds, if desired
    - Clearing and exchange trading requirements are prospective, and do not affect existing contracts; however, increased collateral may still be required

Derivatives Legislation

- Senate Bill: Wall Street Transparency and Accountability Act of 2010
  - Similar to House proposal, except:
    - Adds fiduciary duties for securities-based swap dealers entering into swaps with pension or retirement plans, or state, federal or municipal entities
    - Limits exemption of clearing and exchange-trading requirements for derivatives contracts to end users using swaps to hedge “commercial risk”
    - Prohibits federal assistance (i.e., FDIC insurance, Federal Reserve lending or bailout assistance) to swap dealers and MSPs
      - Would effectively eliminate bank participation in derivatives
      - Would likely result in spinoffs of banks’ proprietary derivatives trading desks, although recent proposals may permit banks to move derivatives operations into an affiliate under the same parent company
    - Provides for increased regulation of FX swaps

Changes Within the SEC's Enforcement Division:

Impact on Hedge Funds

A Revamped Enforcement Regime

- What Does This Mean for Hedge Funds and Their Advisers?
  - New SEC Leadership with Vested Interest in Success of Reforms

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  - Registration, Compliance Requirements, Inspections, Risk-Based Sweeps

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  - Specialized High-Profile Unit, Industry Expertise, Institutional Knowledge

+

  - Streamlined Processes, Invigorated Staff, More Authority, Swifter Action

+

  - Public Outcry, Political Pressure, Regulatory Turf Battles

= More SEC Enforcement Activity

Structural and Policy Changes

- A Swifter SEC
  - Eliminating a layer of management and restricting the use of tolling agreements.
  - Delegating authority to obtain formal orders and issue subpoenas.
  - Streamlining the Wells process and other processes.
- Increased Credit for Cooperation
  - Developing "Seaboard-type" factors for individuals.
  - Adopting DOJ-style deferred- and non-prosecution agreements.
  - Expedited process for securing criminal immunity requests.
- Office of Compliance and Inspection Examinations
  - Support of Enforcement's specialization initiative through sweep examinations.
  - New procedures for third-party verification of information obtained in examinations.
- SEC Enforcement Manual (October 2008)
  - Greater transparency in investigative process and charging decisions.
  - Formalization of policies: privilege waivers, contact with senior staff during investigation, parallel proceedings, access to investigative files, closing process.
- Other Madoff Inspired Changes
  - Dedicated complaint center: Office of Market Intelligence.
  - New Division of Risk, Strategy and Financial Innovation.

Enhanced Specialization

- Five Specialized Units
- Referred to as the Division's **"biggest reorganization in at least three decades."**
  - Asset Management Unit: Largest of new units; focus on Investment Advisers, Investment Companies, hedge funds and private equity funds; unit will address disclosure, valuation, portfolio performance, due diligence, diversification transactions with affiliates and conflicts of interests.
  - Market Abuse Unit: Large-scale market abuses and complex manipulation schemes by institutional traders and market professionals and others; new screening technology tools to analyze trading data across debt, equity, and derivatives.
  - Structured and New Products Unit: Complex derivatives and financial products, including credit default swaps, collateralized debt obligations and other securitized products.
  - FCPA Unit: Focus on new approaches to identifying violations; more cooperation with foreign counterparts.
  - Municipal Securities and Public Pension Unit: Offering and disclosure issues, tax, or arbitrage driven activity, under-funded liability and pay-to-play.
- Asset Management Unit Will Be the Largest Unit With the Highest Profile

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Asset Management Unit Priorities

- Potential Enforcement Cases
  - False Disclosures
  - Valuation
  - Portfolio Performance
  - Safekeeping of Assets
  - Redemption Issues
  - Selective Disclosures
  - Record Keeping
  - Failure to Supervise
  - Misappropriation
  - Insider Trading
  - Due Diligence
  - Conflicts of Interest
  - Affiliate Transactions
  - Placement Agents
  - Complex Derivatives
  - Municipal Securities
  - Public Pension Fund Investments
  - Market Manipulation
  - Improper Short Selling
  - Rumors

Ongoing Attention to Internal Controls

- Hedge funds must be vigilant about implementing and monitoring internal procedures to insure compliance with regulatory and fiduciary obligations.
- Occasional testing of compliance procedures will reveal need for enhanced training, and if appropriate, sanctions arising from prohibited conduct.
- Regulators current focus on “insider trading” at hedge funds is not going away; the need for an effective trading policy has never been greater, and will shield fund from allegations of fostering a non-compliant culture.

Ongoing Attention to Internal Controls (continued)

- Assessment of internal controls should be "risk-based" and focused on areas of material significance that are important to the fund:
  - Domestic vs. Offshore Capital Raising;
  - Anti-Money Laundering concerns;
  - Market Participation and Trading, including (a) interactions with broker/dealers, (b) Section 13 and 16 disclosures, and (c) short-selling;
  - Fund Managers (fully disclosed) and Fund Investors (appropriately informed);
  - Portfolio Management, including (a) principal and agency cross transactions, (b) trade aggregation and allocation, and (c) portfolio valuation.

When the Government Calls …

- From FBI agents at the door to a telephone call from SEC staff, the early steps are the most important ones.
    - Early Intervention — get experienced counsel involved early, retention decisions are often made within the first 24 hours of government contact; first call is often to the corporate attorneys.
    - Assume the Worst — no such thing as a casual FBI drop by or SEC call; investigators will know more than they let on, and are looking to lock witnesses into an incorrect or false story; heightened risk of parallel criminal investigations, especially in today's environment.
    - Get in Front of Investigation — look to maximize the benefits of cooperation while minimizing exposure; establish early credibility, negotiate scope of document requests, be complete, and work to avoid escalation into formal investigation.
    - Prepare a Comprehensive Defense — document preservation and privilege issues, fact investigation and witness interviews, tactical issues and collateral concerns.

Tax and Reporting Developments

Carried Interest Tax Legislation

- Current law – income from carried interest performance allocation “flows up”
  - has same character as underlying income, where partnership is investment vehicle
  - Long-term capital gain taxed to individual at 15% top federal note (scheduled increase to 20% in 2011)
- House has passed bill to tax carry, and any other income with respect to “investment services partnership interest,” as ordinary income
  - current top federal rate of 35%, scheduled rise to 39.6% in 2011
  - would also subject income to self-employment tax
- 2011 Administration Budget would also tax income and gain from a “services partnership interest” as ordinary income – generally follows House bill
- No grandfather rules in either
- Senate has not passed any carried interest legislation

Foreign Account Tax Compliance (FATCo)

- IRS believes bank secrecy laws in other countries make it difficult for IRS to track U.S. ownership and activity where assets and income are "hidden"
- March Legislation
  - Imposes new 30% withholding tax on payments to many non-U.S. entities unless those payees disclose certain information about U.S. account holders and owners
  - Adds new disclosure rules for U.S. individuals who own non-U.S. assets

FATCo's New Withholding Taxes

- 30% on certain payments to foreign financial institutions ("FFIs") and non-financial foreign entities ("NFFEs")
- Much broader scope of withholding than under former law
  - includes U.S. source compensation
  - includes gross proceeds (not just gain) on sale of U.S. stock and U.S. debt instruments
- Applies even where treaty or portfolio interest exemption would reduce or eliminate withholding
- Withholding agent liability
- Effective for payments after 12/31/2012
  - Grandfather rule for debt obligation issued on or before 3/18/2012
  - No grandfather for equity investments

Exemption From FATCo Withholding

- If recipient is FFI (bank, broker, entity "engaged in the business of investing")
  - Enter agreement with IRS to (among other things):
    - identify direct and indirect U.S. owners
    - report annually to IRS on such owner's name, account number, taxpayer ID and account activity
    - withhold from owner that does not provide this information
  - Comply with future IRS guidance to ensure no direct or indirect U.S. accounts
- If recipient is NFFE, either certify that it has no 10% or greater U.S. owners, or provide list of 10% or greater U.S. owners

Foreign Bank Account Reporting (“FBAR”)

- Bank Secrecy Act requires each U.S. person who holds financial interest in, or has signature or other authority over, foreign financial account exceeding $10,000 (in aggregate) at any time during calendar year to file Form TD F 90-22.1 with Treasury Department by 6/30 of following year
- In 2009 IRS stated non-U.S. hedge fund and private equity fund interests are “financial accounts” required to be reported
- Notice 2010-23 says “no they are not” – for 2009 and prior years
- Treasury discussion seems to indicate they are not likely to be so treated, for FBAR purposes, going forward – in large part, because of FATCo
- Signature authority over foreign financial account still subject to FBAR, but filing deadline extended to June 30, 2011

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