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Changes in French Alternative Investment Fund Structures


by **Olivier Dumas** and **Jelena Vodjevic***

Moves by the French Authorities to Modernize Financial Activities in France

Over the last decade, France has progressively developed its alternative investment industry, the latest milestone being a recent set of laws and regulations implemented in 2008 (the “2008 Regulations”) which aim to modernize the French alternative investment industry and enable it to compete with offshore offerings.

The French financial regulator (the “*Autorité des Marchés Financiers” – “AMF”*) has, from an early stage, undertaken to provide some of the flexibility lacking under the provisions of the European UCITS framework, to investors deemed to be more experienced than the retail public. In April 2003, the AMF issued a position paper in which it started to build a regulatory framework for such activities, acknowledging the practice of French funds investing in offshore hedge funds. The legal framework was soon further developed by the 2003 Financial Security Law which introduced a new range of regulated funds reserved for specific categories of investors.

Onshore alternative investment vehicles were thus created, benefiting from more relaxed investment rules than UCITS. The first category of funds is designated “OPCVM *à règles d’investissement allégées”* (UCITS governed by relaxed investment rules), also known as “OPCVM ARIA”, and is made up of three types of investment funds: Standard ARIA, ARIA funds of funds and leveraged ARIA. Alongside OPCVM ARIA, the Financial Security Law also created a “Contractual OPCVM”, a very flexible vehicle

characterized by the absence of any mandatory investment rules or ratios, which are instead set out in its by-laws.

The 2008 Regulations have taken France on a further step on the road to such "contractualization" of fund terms and satisfying institutional investors' specific needs. The liquidity crisis has clearly prompted changes to the existing framework, in an attempt to provide investment funds with the tools to manage crisis situations. In this respect, the law now provides for "gates" and "lock-up" mechanisms for OPCVMs ARIA and Contractual OPCVMs, enabling them to suspend redemptions as long as necessary to manage illiquid assets.

The categories of eligible assets in which Contractual OPCVMs can invest have also been widely expanded. Today, eligible assets are very broadly defined. A Contractual OPCVM can hold different sorts of assets, including those which are not necessarily financial instruments, as long as these assets comply with some simple requirements: ownership of the asset must be documented by a deed of property and the assets must be subject to a reliable valuation process. As a result, the 2008 Regulations allow for assets such as patents, trademarks, real estate, intellectual property rights and copyrights, to mention but a few examples, to be held by Contractual OPCVMs.

Creation of New Onshore Vehicles Dedicated to Institutional Investors and Adapted to Market Needs

The 2008 Regulations enabled the development of collective investment in three sectors: private equity, real estate and debt funds.

As for the private equity sector, before the 2008 Regulations entered into force, a relatively well developed range of private equity investment vehicles already existed: FCPR *agréé* – dedicated to retail investors with the AMF's prior approval; FCPR *à procédure allégée* – dedicated to qualified investors without the AMF's prior approval; FCPI – dedicated to investment in high tech companies; and FIP – dedicated to investment in SMEs.

FCPR *à procédure allégée* is the main vehicle used for private equity investment projects. Prior to the 2008 Regulations, however, this vehicle was subject to certain restrictive limitations; in particular it could not invest in private equity funds that were not domiciled in OECD countries. The 2008 Regulations have withdrawn this limitation and the FCPRs *à procédure allégée* are now allowed to invest in private equity funds wherever they are located.

The noteworthy innovation of the Law is the creation of a new type of vehicle dedicated to private equity, and, in fact, to a large range of alternative investments – the "Contractual FCPR". This vehicle affords more flexibility in many respects. It is available to qualified investors only (as with the FCPR *à procédure allégée*) and investment rules may be freely determined by the parties (as with the Contractual OPCVM).

There is consequently no compulsory investment zone or maximum and minimum investment rules, no restrictions on borrowing funds, no investment ratios in non-listed companies, and a large freedom for the financial organization of shares, etc. The contractual FCPR is not subject to the prior approval of the AMF, but it has to file a declaration of creation *post facto*. Its management company, however, in addition to its authorization to provide investment services in France, must be authorized with respect to the alternative investment activity programme it intends to carry out (*"programme d'activité"*). In November 2009, the AMF published rules concerning disclosure procedures and rules on providing information to fund investors in the prospectus of Contractual FCPRs.

This updated legal framework makes this new vehicle efficient for investing in funds, private equity, real estate and infrastructure, to name but a few possibilities, throughout the world and without restrictions.

The wider possibilities for collective investment in real estate through Contractual FCPRs and OPCVMs were developed concurrently with the establishment of several funds dedicated specifically to real estate investment and known as OPCIs and OPCIs *à règle d'investissment allégées*, with or without leverage. These structures have been available since 2005 and are well suited to the needs of institutional investors.

The OPCI was created as a response to the shortcomings of the existing SCPI (*société civile de placement immobilier*) which is attractive mainly to retail investors. OPCIs' advantages over SCPIs are the institutional prudential and dynamic management, the enhanced liquidity and the more flexible tax regime they offer. The 2008 Regulations enacted minor corrections to the applicable rules so as to achieve greater consistency between the regimes applicable to the different OPCIs.

Finally, the 2008 Regulations have implemented new rules regarding debt funds, with the creation of *Organismes de titrisation*, which include *Fonds Commun de Titrisation* (FCT) and *société de titrisation*.

These vehicles have a purpose which is much larger than their predecessor, the *Fonds Commun de Créance* (FCC, replaced by such vehicles pursuant to the 2008 Regulations). The purpose of the new vehicles is (i) to provide exposure to risks, including insurance risks, by acquisition of receivables or by entering into agreements to create futures or to transfer risks insurance, and (ii) to finance or provide coverage of risks, by issuing equity shares or debt instruments, or by entering into agreements to create futures or to transfer risks insurance, or by borrowing.

These vehicles must be managed by a French management company regulated by AMF. They can be created as an umbrella fund, with several sub-funds. The rights of shareholders, bond holders, and certain other creditors, with respect to the assets, income and distributions of the fund, can be established in the fund's by-laws. There is no limitation upon such vehicles' investments (e.g., with respect to investment ratios or other risk ratios). Such vehicles can be commercialized in the context of a public offering (with the AMF approval of the prospectus) or pursuant to a private placement.

Tightening the Internal Organization Duties of Management Companies

Although French regulations seek to achieve greater flexibility in the collective investment products offered, the vehicles nonetheless remain tightly supervised. This supervision is the result of strict marketing and compliance rules, deriving from the implementation in November 2007 of the Markets in Financial Instruments Directive (MIFID) by the AMF.

Whereas MIFID seemed to liberalize the investment services activities by reinforcing competition between trading venues, the AMF has decided to subject asset management companies to MIFID rules concerning internal organization and marketing process for the funds they manage.

The AMF has somewhat twisted the internal organization requirements contained within MIFID so as to impose new compliance requirements for management companies. The AMF has, for example, reinforced management companies' obligations regarding advice and best practices concerning, in particular, the marketing of financial products. Put in practice, this rule notably requires that internal procedures be put in place to require client categorization and the processing of any client request to change categories.

The AMF has also stretched the scope of MIFID rules relating to risk management and prevention of conflicts of interests, so as to cover collective investment and management companies. Management companies are required to have a compliance officer and to establish policies designed to avoid conflicts of interests, risky practices and non-compliant behavior.

As regards the contractual vehicles (contractual OPCVMs and contractual FCPRs), management companies that elect to manage such vehicles are subject to strict supervision by the AMF. Although

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investment rules and ratios for such vehicles may be freely determined by the parties, the AMF will require that the management company that undertakes to manage such a vehicle has the technical means and human resources to check that these rules are complied with at all times. The riskier the activity, the more processes will be expected to be put in place by the management company, so as to efficiently manage such risks.

Reinforcement of Investment Funds' Marketing Rules and Management Company Duties

The marketing of UCITS units is authorized and controlled in France by the AMF, which has taken on the task of applying MIFID to such activities. Compliance requirements derived from MIFID are chiefly concerned with the supervision of the marketing of the funds, which is the management company's responsibility.

Firstly, the AMF requires firms to categorize clients as "eligible counterparties", professional clients or non-professional clients (the last benefiting from increased levels of protection). Clear procedures must be put in place to categorize clients and assess their suitability for each type of investment product. This being said, the appropriateness of any investment advice or suggested financial transaction must be verified before being given/entered into. This process is supposed to lead firms to "know their customers", by focusing on clients' investment objectives, risk and investor profiles, and to ensure that the products and services that they provide are suitable or appropriate for their clients.

The marketing process is regulated by the General Regulation of the AMF and also by two sets of guidelines published in 2009 by the AMF in relation to the drafting of the prospectus and marketing documents of funds commercialized in France. The AMF provides industry players with examples and guidelines so as to understand what are compliant marketing practices and what are not. The information contained in the prospectus must be "fair, clear and not misleading". This means that it shall be easily understandable by potential investors and relevant for clients to make an informed investment decision.

Regarding risk and investor profiles, the AMF recommends a standardization of risk factors to facilitate comparisons with other funds, and so that only relevant information is mentioned. Furthermore, whenever possible, the potential impacts of investment decisions or strategies must be discussed. The AMF also requires that the prospectus indicate: target investors; and whether the funds are designed for experienced investors or not, and the level of risk to which the investors are exposed.

The marketing documents aimed at the public must also be "fair, clear and not misleading", and it is the management company's duty to ensure that the information it publishes is suited to all potential clients, and in conformity with the information mentioned in the prospectus.

Information may not emphasize any potential benefits without also giving a fair and prominent indication of any relevant risks, and may not disguise, diminish or obscure important items, statements or warnings. Information must be presented in a manner likely to be understood by the average member of the group to whom it is directed, or by whom it is likely to be received, and may not be incomplete or distorted so as to highlight only positive aspects of the product.

Conclusion

The large-scale movement of regulation over several years has proved to be trying for the investment industry. The initial fog of uncertainty has been lifted and a quite complete and elaborate system has emerged, allowing for a diversified offering of vehicles as well as a secure sales and marketing framework for investors.

The problem with sophistication is undoubtedly its cost. The question is whether, in these current times of a crisis of trust in the financial system, investors will be prepared to pay the price for increased security.

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FIN 48 – Accounting for Uncertain Tax Positions

  

by **Mark Stapleton, Michael Hirschfeld** and **Jim Baird**

Tax considerations for funds have taken on a new dimension of concern in the face of U.S. GAAP financial accounting rules that for the first time will require funds to reserve for particular uncertain tax positions and proposed U.S. tax rules that would require disclosure of those reserves to U.S. tax authorities.

These tax reserves could apply (amongst other things) to profits derived from funds' trading activities in certain countries and will require reserves for particular uncertain tax position taken from the inception of the fund if the relevant tax authorities can still bring a claim.

The potential consequences for funds include possible adjustments to net asset values with associated concentration and dilution issues for investors.

Funds will need to address these issues as early as possible in order to identify and take proactive steps to minimise these tax exposures and some of the difficulties that may result. Steps should also be taken to disclose to investors any potential risk of tax provisions being required and also to limit disclosure to what is truly mandated.

Background

ASC 740 (formerly "FIN 48") is an interpretation issued by the U.S. Financial Accounting Standards Board ("FASB") giving guidance on how to recognise and measure uncertain tax positions.

Although FIN 48 was issued in June 2006, the FASB deferred its application to certain non-public entities (including many investment funds) for two years. However, with the publication of Accounting Standards Update 2009-06 (the "ASU"), FIN 48 will, with some slight adjustments, now apply to non-public entities (including many private investment funds) that have not already adopted FIN 48 for fiscal years beginning after 15 December 2008 (assuming they report under U.S. GAAP). Thus, many funds will, for the first time, now be facing the imminent need to address specific criteria for the recognition and measurement of uncertain tax positions for the fiscal year ended 31 December 2009.

In addition, with the current initiative to converge U.S. GAAP and International Accounting Standards ("IAS"),

the International Accounting Standards Board ("IASB") has issued an exposure draft to IAS 12 which could introduce requirements similar to FIN 48.

Furthermore, the IRS has recently announced a proposal for a new reporting rule that would require many entities to disclose tax positions made under FIN 48 with the potential to increase the likelihood of assessment.

Therefore, many funds, whether onshore-U.S. or offshore and whether accounting under U.S. GAAP or IAS, will now be facing the current reality, or future possibility, of having to recognise uncertain tax positions under a "more likely than not" test on the assumption that the relevant liability will be examined, rather than on a "probable of occurring" test under the FAS 5.

What is an Uncertain Tax Position?

A "tax position" for FIN 48 purposes is broadly defined. For many funds, potential tax liabilities in jurisdictions where they invest will be of primary relevance. For example, there is a substantial list of countries in which there is a possibility of a fund being assessed to tax on profits derived from trading in their underlying investments in that jurisdiction (including China, India, Spain and Australia, to name but a few). Other potential tax positions that would require disclosure include: the recognition of the taxable status of the fund entity; the existence of a nexus with, or agency in, a taxable jurisdiction (such as through a local investment manager/adviser); permanent establishment risk; loan origination activities that may lead to an offshore entity being treated as carrying on an onshore business; application of transfer pricing principles; the availability of trading safe harbours; and the possibility of being deemed to have publicly traded partnership status.

Where before there would have been greater flexibility under FAS 5 as to how to recognise and measure these potential tax positions, there will now be more prescriptive rules to determine whether and to what extent the position should be recognised.

Recognition and Measurement

Under FIN 48, whether a tax position is required to be recognised will be a determination based on the individual facts and circumstances. FIN 48 provides that enterprises shall initially recognise a tax position when it is "more likely than not" that a particular position would be sustained upon examination. In this context "more likely than not" means a likelihood of more than 50% that the position would be upheld following any rights of appeal. If a position that no tax is payable does not meet the "more likely than not" test, then the full amount of the liability must be accrued. In applying this test, it is important to note that the test will be applied on the assumption that the relevant taxing authority has full knowledge and all relevant information. Accordingly, for the purposes of determining the need for a reserve, it would be assumed that all necessary filings have been made.

Even where a position that no tax is payable is sustainable on a "more likely than not" test, it is still necessary to make a partial provision if, for example, there is a greater than 50% likelihood that part of the tax liability would become payable. This requires careful consideration although in many cases it may not be relevant if the associated analysis concludes that the tax is either payable in full or not at all.

Issues for Funds

Clearly, for funds reporting under U.S. GAAP, the issue of recognising tax positions will be an immediate concern for the fiscal year ended 31 December 2009. In addition, for funds reporting under IAS, there is a prospect of similar rules in the future. A number of issues flow from this.

Investigating Tax Liabilities in Overseas Jurisdictions

As noted above, potential overseas tax exposures of funds may require recognition. Early action is therefore recommended to ascertain the potential scope of such liabilities. It should be noted that where a liability exists and remains unpaid, the extent of the exposure could grow substantially due to the addition of penalties and interest. In contrast, if the liability is identified early, steps can be taken to mitigate the exposure (see "Mitigation Measures").

By way of example, we are aware that trading activity of funds in Australian equities listed on an Australian exchange is a potential problem area. We understand that the statute of limitations will not begin to run in Australia unless and until filings are made, so that any potential tax exposure could continue to increase unless action is taken to avoid this.

Impact on Net Asset Value

There may be a significant difference between the amount required to be recognised under FIN 48 and the amount of tax positions recognised in previous audits (or for that matter those likely ever to materialise). However, the issue is not simply confined to the audit, as there is also the question of how and to what extent the positions will need to be reflected (if not already) in the fund's net asset value.

Where the valuation policy of the fund exactly follows the accounting treatment, there may be an immediate drop in net asset value on recognition for the first time of uncertain tax liabilities. Clearly this will have an impact on investors coming into and redeeming from the fund (if open-ended). Those who redeemed before a downward adjustment would clearly benefit at the expense of continuing investors. Similarly, investors coming in at the reduced net asset value may benefit to the detriment of existing investors, particularly where the tax liability is contingent and unlikely ever to be settled. These adjustments would also affect track record and management and performance fees.

Some funds (whose constitutions and governing regulations permit) may seek not to fully reflect uncertain tax positions in their net asset values and to simply disclose a discrepancy between the audit and the net asset value. However, there may be limits to how far these exceptions can be justified, in particular if the tax liability continues to increase. Further, the existence of potential liabilities (either static or increasing) may act as an incentive for investors to redeem for fear of being left with the residual liability.

There will be a number of different approaches to addressing these issues and the approach will be driven by the circumstances in each case.

If funds do reflect the tax positions in their net asset values, but these positions are nonetheless unlikely to materialise, specific mechanisms may be required in order to secure fair treatment of investors trading into and out of the fund. Potential solutions would include side-pocket mechanisms, forms of equalisation and the use of series accounting, to name a few.

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The New Climate of Disclosure for Hedge and Private Equity Funds


by **Gus Black** and **Janice Houghton**

Introduction

The topic of disclosure is certainly in vogue at the moment. Within recent weeks both the International Organization of Securities Commissions ("IOSCO") and the Committee of European Securities Regulators ("CESR") have released separate proposals on hedge fund information disclosure requirements. Whilst IOSCO published a template for harmonised data collection by regulators, CESR recommended the introduction of a pan-European disclosure regime in relation to short selling – an initiative which sits alongside various evolving regulatory actions on short selling elsewhere in the world.

The trend continues in the UK private equity sphere, with the publication of a guide to good practices on transparency and disclosure by the Guidelines Monitoring Group ("GMG"), an independent body set up following the 2007 Walker review of the adequacy and transparency in private equity.

Meanwhile, as the UK Financial Services Authority (the "FSA") publishes a report analysing the link between hedge funds and systemic risk (and concluding that there really is not much of one), politicians in Brussels continue to use the idea of just such a link

to justify the imposition of wide-ranging disclosure requirements on alternative asset managers of all kinds in the form of the proposed European Directive on alternative investment fund managers (the "AIFM Directive").

Short Selling

The CESR "Model for a Pan-European Short Selling Disclosure Regime" advocates the introduction of permanent, harmonised short selling disclosure obligations. For more details on the CESR proposals and regulatory measures in this area in Germany, the United States and Hong Kong, please refer to the *DechertOnPoint* dated March 2010, "Recent Short Selling Developments" available at http://www.dechert.com/library/FS_5_03-10_Recent_Short_Selling_Developments.pdf.

IOSCO Hedge Fund Data Template

On 25 February 2010, IOSCO's Technical Committee published an agreed template for use by national regulators to collect data on hedge funds from local hedge fund managers and advisers to help assess and monitor possible systemic risks arising from the hedge fund sector.

The template seeks to establish a globally consistent approach amongst regulators and to enable collection and exchange of comparable data. It was developed by IOSCO's Task Force on Unregulated Entities following requests by the Financial Stability Board and IOSCO members. In developing the template, the Task Force has built on the Technical Committee's June 2009 Report on Hedge Funds Oversight, which originally envisaged such monitoring taking place either at the fund or manager level, depending on local conditions.

The Task Force has recommended that regulators should carry out an exercise to gather data from fund managers using the template in September this year. However this is to be on a "best efforts" basis given pending legislation in some jurisdictions and individual regulators may include further information requirements in addition to those set out in the template.

In summary, the template covers the following eleven types of information:

1. *General manager and supervisory information* – supervisory information, which regulators generally already have available (e.g., information about the manager and its principals, staff and structure, as well as information on its key service providers – such as prime brokers and custodians, auditors, administrators and other outsourcing arrangements);
2. *Performance and investor related information related to covered funds* – details on performance, subscriptions and redemptions, net asset values and high watermarks, investor make-up and marketing channels;
3. *Assets under management* – information to be provided on a group-wide basis (total AUM and individual hedge fund AUM);
4. *Gross and net product exposure and asset class concentration* – details of material positions in various asset classes (including, where relevant, the geographical split);
5. *Gross and net geographic exposure* – high-level information on regional investment focuses and the underlying currency of assets;
6. *Trading and turnover issues* – turnover in various asset classes and details of the clearing processes used;
7. *Asset/liability issues* – details of asset liquidity, investor liquidity demands (presuming use of all available liquidity tools such as gates – but not suspension), term financing, side pockets and other techniques available to manage liquidity risk;
8. *Borrowing* – value of such borrowings by source and from regulated vs. unregulated entities;
9. *Risk issues* – details of unencumbered cash, risk measures and mechanisms used to assess tail risk;
10. *Credit counterparty exposure* – details of net credit counterparty risk (primary counterparties and their locations) and extent of rehypothecation (including contractual limits on this); and
11. *Other issues* – information on complexity (such as size of options book and number of open positions) and concentration (such as top ten positions as a percentage of gross market value).

Members of IOSCO's Technical Committee include representatives from the British, Dutch, French, German, Spanish and Swiss regulators – who are among those currently debating (with varying degrees of agreement) the draft AIFM Directive which, of course, contains its own set of proposed disclosure requirements.

Disclosure Obligations Under the AIFM Directive

The AIFM Directive seeks to manage perceived risks to the financial system associated with activity by alternative investment managers. One of the ways in which it seeks to do this is to specify types of information that fund managers would be required to provide to their relevant "home state" regulator. The recent Spanish Presidency-proposed text of the AIFM Directive would require disclosure of details such as:

- persons conducting the manager's business;
- the manager's organisational structure – information on the funds it manages, such as investment strategies and risk profiles, including information on the countries in which they are located;
- the funds' constitutional documents;
- any delegation by the manager;
- custody arrangements;
- the manager's capital;
- side pocketing/illiquidity arrangements in place in respect of funds managed and other liquidity management tools available;
- the funds' assets and the tools used to manage risk;
- the funds' use of short selling and leverage (including the identity of the five largest borrowing sources); and
- the results of stress testing required by the AIFM Directive to monitor risks associated with investment positions and liquidity profiles of the funds managed.

These requirements sit alongside disclosures the AIFM Directive would require fund managers to provide to investors (including investment strategy and risks, and use of leverage, as well as pricing methodology, liquidity risk management and management and depositary arrangements).

As long a regulatory shopping list as this is, it is worth remembering that much of the information sought would already be disclosed in a hedge fund offering document of any reasonable quality. However, some would not; and in this regard, if these requirements come to pass, all eyes will be on the more detailed regulations to be made as the "Level 2" part of the AIFM Directive process to see how some of these general requirements are interpreted.

Many of these requirements overlap with those in the IOSCO template and, consistent with IOSCO's approach, the AIFM Directive envisages information sharing powers allowing cross-border supervisory cooperation; accordingly, the IOSCO template may therefore be a potential standardised means of collecting the information specified in the AIFM Directive. However, under the AIFM Directive, the European Commission would also be able to implement further requirements to provide information to facilitate the monitoring of systemic risk. The latest draft proposal is mindful of the need to avoid excessive administrative burdens in implementing disclosure requirements – but, unfortunately, solely in the context of minimising burdens on regulators themselves. We can but hope that a joined-up approach will prevail in the end.

Many of these requirements overlap with those in the IOSCO template and, consistent with IOSCO's approach, the AIFM Directive envisages information sharing powers allowing cross-border supervisory cooperation.

Private Equity Disclosures

In November 2007, the British Private Equity and Venture Capital Association commissioned the publication of the Guidelines for Disclosure and Transparency in Private Equity ("Guidelines"). The Guidelines proposed an enhanced disclosure regime (via annual reports and websites) for significant private equity portfolio companies.

The GMG, which was established to oversee the operation of these guidelines, has recently published a document entitled *"Improving Transparency and Disclosure"* which aims to provide practical assistance to private equity-owned portfolio companies to improve transparency and disclosure in their reporting. It contains suggested disclosure good practices for sections of companies' annual reports dealing with information such as board composition, financial information, business review, market environment and various other matters.

Following a consultation process, the GMG has announced the lowering of the enterprise value threshold (triggering application of disclosure requirements under the Guidelines) from £500 million to £350 million (or £210 million in the case of public to private transactions).

The Guidelines – fundamentally a self-regulatory initiative – sit in contrast to the mandatory and rather more indiscriminate regime that the AIFM Directive would impose on private equity managers. Some of the disclosures required of funds taking significant positions in private companies are clearly motivated by political, rather than financial regulatory, considerations. For example, disclosure of the private equity manager's plans for the future business of the company, and its proposals as regards the safeguarding (or otherwise) of jobs for employees. The strategic disadvantage at which this would place private equity funds in contrast to other business owners has been widely noted. However, rather than removing such requirements, the proposed EU compromise position is instead to "re-level the playing field" by conducting a European-wide company law review – followed by further legislative amendments to impose such requirements on other types of controlling shareholders. The position will no doubt continue to evolve as the political process continues.

FSA Assessment of Current Hedge Fund Impacts

In February, the FSA published a report entitled *"Assessing possible sources of systemic risk from hedge funds"*, based on the results of a hedge funds as counterparty survey ("HFACS") of FSA-authorised banks with credit exposure to hedge funds and a hedge fund survey ("HFS") of around fifty of the largest FSA-authorised investment managers, with more than $300bn of assets under management.

The report takes a two-pronged approach to assessing what impact hedge funds may have on systemic risk: (a) analysis of the risk of hedge funds' losses destabilising systemically important creditors based on HFACS information gathered from prime brokers (such as the size of credit exposure they have to individual hedge funds, those funds' activities, the average margin required from them and details of excess collateral held); and (b) analysis of the potential market impact of large investments by hedge funds in certain asset classes based on HFS information gathered from investment managers (such as data on funds' "footprint" of positions held as compared to the equity raised from investors – a measure used in order to assess levels of leverage, as well as data on funds' borrowing, the liquidity of funds' investments and the liquidity profile of funds' liabilities to investors and finance providers).

HFACS data has been collected semi-annually for the past five years, with the HFS being introduced in October 2009 to widen the scope of data collected.

In the report, the FSA concluded that the HFACS and HFS data gathered in October 2009 suggested that "hedge funds did not pose a potentially destabilising credit counterparty risk across the surveyed banks", that funds' use of leverage was relatively low and that there was no clear evidence to suggest "that any individual fund posed a significant systemic risk to the financial system at the time".

The Alternative Investment Management Association ("AIMA") has commented that the low leverage levels shown by the HFS and the FSA's difficulty in finding one measure of leverage cast new light on the AIFM Directive's attempts to define and place limits on leverage, and notes that the Basel Committee on Banking Supervision is also looking at definitions of leverage ratios for international banks and how these might be used for funds.

The FSA is seeking to feed into the work underway on the AIFM Directive as well as discussions between IOSCO and the Financial Stability Board to ensure consistency of timing and types of data required. The FSA intends to continue to conduct these surveys on a semi-annual basis to build a longer-term time series of data, which will assist in monitoring potential systemic risk impacts of hedge fund trends.

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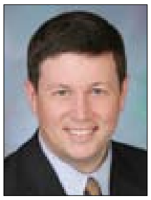
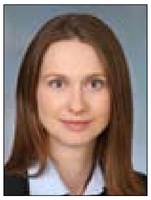
OFAC Issues Final Rule on Economic Sanctions Enforcement Guidelines





by **Thomas C. Bogle** and **Jeanette Wingler**

Introduction

The United States has imposed embargoes and sanctions of different degrees (collectively "sanctions") on a variety of jurisdictions – including Burma, Cuba, Iran, Sudan and Syria – as well as certain designated individuals and entities deemed to have engaged in activities against the interests of the United States (e.g., terrorism or narcotics trafficking). The Office of Foreign Assets Control ("OFAC") is the bureau of the United States Department of the Treasury that is charged with administering and enforcing these sanctions.[1] Although one government entity is charged with administering and enforcing U.S. sanctions, the jurisdictional scope and requirements of these sanctions may vary substantially depending on the type of sanctions regime involved. Moreover, because strict liability is imposed for violations, it is easy for one to inadvertently run afoul of U.S. sanctions.

OFAC has long recognized that the enforcement response should vary depending on the type of violation.

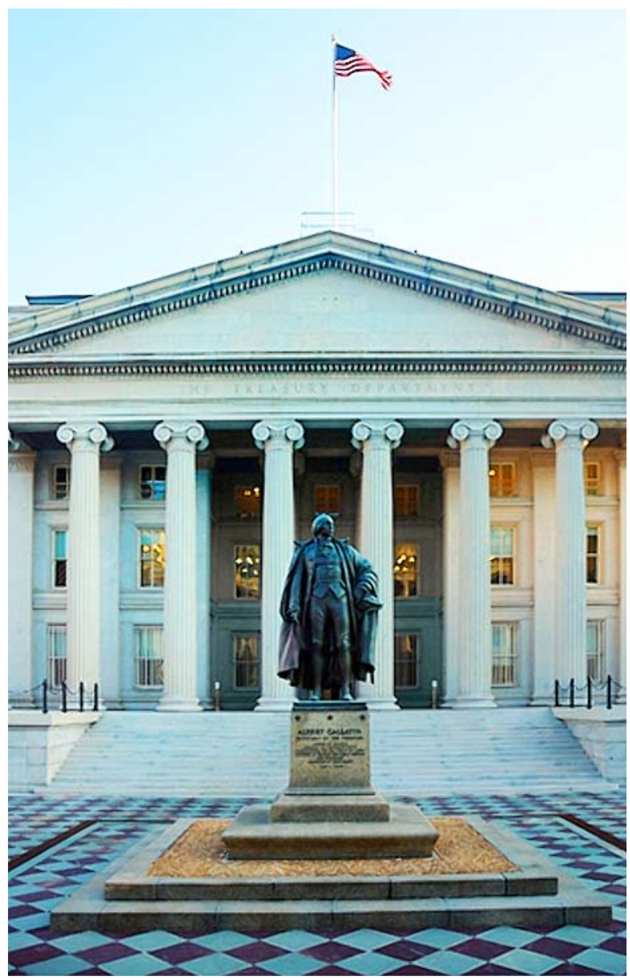
OFAC has long recognized that the enforcement response should vary depending on the type of violation. For example, a financial institution with a robust risk-based compliance program that nonetheless has a violation, should not be treated in the same manner as a financial institution that is willfully blind to its OFAC obligations. On November 9, 2009, OFAC issued the Economic Sanctions Enforcement Guidelines (the "Guidelines"), an immediately effective final rule setting forth its formal guidelines for the enforcement process for sanctions violations.[2] The Guidelines do not impose additional obligations on any person, but rather serve as enforcement guidance for persons subject to the requirements of U.S. sanctions statutes, executive orders and regulations enforced by OFAC (collectively, "Subject Persons").[3]

Factors Affecting Administrative Action

General Factors

The Guidelines adopt a standard approach to the enforcement process for resolving "apparent violations" and set forth several general factors that may be considered by OFAC in determining the appropriate enforcement response.[4] The general factors identified as affecting administrative action include:

- Whether the violation was willful or reckless;[5]
- Whether the alleged violator was aware of the conduct, activity or transaction giving rise to the subject violation;



- The extent of the harm caused to the objectives of the sanctions program;
- The individual characteristics of the alleged violator, such as its size, volume of transactions, commercial sophistication and sanctions history;
- Whether the company had a compliance program in place at the time of the apparent violation;
- Whether the alleged violator took corrective action in response to the apparent violation;
- The extent of cooperation with OFAC's investigation;
- The timing of the apparent violation relative to the imposition of sanctions;
- The existence/status of other pending enforcement actions undertaken by other agencies for the same or similar conduct;
- The future compliance/deterrence effect of administrative action, with respect to similar persons, particularly in the same industry sector; and
- Other relevant factors to be determined on a case-by-case basis, including whether the conduct in question is permissible under the applicable law of another jurisdiction.

Voluntary Self-Disclosure

The Guidelines provide that the voluntary self-disclosure to OFAC of an apparent violation will be considered in determining the appropriate OFAC response and, in cases where a civil monetary penalty is deemed appropriate, the penalty amount. To incentivize disclosure, the Guidelines provide that an apparent violation for which a voluntary self-disclosure has been made will result in a base penalty amount at least 50 percent less than the base penalty amount in similar cases that do not involve voluntary self-disclosure.

Voluntary self-disclosure under the Guidelines does not include cases in which a third party is required to and does report to OFAC as a result of the third party having blocked or rejected a transaction in accordance with OFAC's regulation. The rationale for this exclusion is that OFAC is already aware of the violation and, therefore, there is no need to incentivize further notification.[6] However, voluntary self-disclosure does include instances in which a third party failed to notify OFAC as required.

Risk-Based Compliance

Under the Guidelines, OFAC will consider the existence, nature and adequacy of an institution's risk-based compliance program in assessing the appropriate enforcement response to an apparent violation. In addition, the Guidelines provide a repromulgated and consolidated risk matrix that is to be used by all financial institutions in assessing OFAC compliance risks.

Because the sanctions enforced by OFAC are complicated and evolving to meet new challenges and risks, a financial institution may inadvertently run afoul of the sanctions and face a variety of penalties.

Cooperation and Tolling Agreements

Under the Guidelines, OFAC will consider a Subject Person's willingness to waive the statute of limitations in assessing the Subject Person's cooperation with OFAC. Also, while a Subject Person's willingness to enter into a tolling agreement may be considered a mitigating factor, a Subject Person's unwillingness to enter into such an agreement will not be considered.

Potential Administrative Actions

Assessment of Civil Penalties

The Guidelines establish a new process for determining civil penalty amounts in cases warranting their imposition. OFAC will first determine a base penalty amount, primarily based on: the value of the transaction, whether the alleged violation was egregious or non-egregious, and whether there was voluntary self-disclosure. Following an evaluation of the general factors, the base penalty amount will then be adjusted upward or downward. Unless a settlement with OFAC is reached, OFAC will next issue a pre-penalty notice that includes the details of the violation, the proposed penalty and the statutory maximum penalty. Upon receiving the pre-penalty notice, the recipient will be given the opportunity to respond and submit evidence that may warrant a downward adjustment of the penalty.

The development of a risk-based compliance program is an important tool to prevent sanctions violations and may prove useful in arguing for a less severe enforcement response in the event that a violation is found to have occurred.

Other Potential Administrative Actions

Under the Guidelines, OFAC may take any of the following administrative actions with respect to its investigation of an apparent violation:

- *No Action* – If OFAC determines that there is insufficient evidence to conclude that a violation has occurred or that the conduct does not give rise to a level warranting an administrative response, no action will be taken. OFAC will generally issue a letter indicating that the investigation is closed, which represents a final determination unless OFAC later learns of additional related violations or other relevant facts.
- *Finding of Violation* – A Finding of Violation may be issued where the fact of a violation has been established, but a civil monetary penalty is deemed unnecessary.
- *Cautionary Letter* – A cautionary letter may be issued where there is insufficient evidence to conclude that a violation has occurred or a Finding of Violation or civil monetary penalty is not warranted under the circumstances.
- *Request Additional Information* – If OFAC determines that additional information regarding an apparent violation is needed, it may request further information from the Subject Person or third parties, including through an administrative subpoena.
- *Other Administrative Action* – In addition to or in lieu of other administrative actions, OFAC may take other administrative actions, such as denying, modifying, suspending or revoking a license or issuing a cease or desist order.

Implications for Financial Institutions

Because the sanctions enforced by OFAC are complicated and evolving to meet new challenges and risks, a financial institution may inadvertently run afoul of the sanctions and face a variety of penalties. The Guidelines provide that a financial institution's risk-based compliance program will be considered in determining the appropriate OFAC response and, in cases where a civil monetary penalty is deemed appropriate, the penalty amount. Accordingly, the development of a risk-based compliance program is an important tool to prevent sanctions violations and may prove useful in arguing for a less severe enforcement response in the event that a violation is found to have occurred.

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1 OFAC administers and enforces economic and trade sanctions, based on U.S. foreign policy and national security goals, against targeted foreign countries and regimes, terrorists, international narcotics traffickers, those engaged in activities related to the proliferation of weapons of mass destruction, and other threats to the national security, foreign policy or economy of the United States. http://www.treas.gov/offices/enforcement/ofac/.

2 Office of Foreign Assets Control, Economic Sanctions Enforcement Guidelines, 74 Fed. Reg. 57593 (Nov. 9, 2009).

3 Subject Persons include U.S. citizens and permanent residents, entities organized under U.S. law, persons located in the United States and, in limited circumstances (i.e., the Cuban and North Korean sanctions regimes), foreign subsidiaries of U.S. entities. http://www.treas.gov/offices/enforcement/ofac/.

4 "Apparent violation" is defined to include both "an actual or possible violation." Office of Foreign Assets Control, Economic Sanctions Enforcement Guidelines, 74 Fed. Reg. at 57601.

5 OFAC stated that a Subject Person's "good faith reliance on substantiated advice received from the OFAC hotline or from counsel" is subsumed within this general factor. Id. at 57599.

6 Id at 57595. However, the Guidelines provide that in cases where a third person reported the violation but the Subject Person provided "substantial additional information" regarding the violation or other violations, the base penalty amount will generally be reduced 25 to 40 percent. Id. at 57595-57596.

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Anti-Money Laundering Proposals in Hong Kong

by **Angelyn Lim** and **Maggie Hau**

Background

The Hong Kong government has published consultation papers on a legislative proposal to enhance the anti-money laundering ("AML") regulatory regime applicable to the local financial services industry.

Currently, AML requirements and obligations applicable to financial intermediaries derive from a number of pieces of legislation, primarily the Organized and Serious Crimes Ordinance (Cap. 455, Laws of Hong Kong), and the Drug Trafficking (Recovery of Proceeds) Ordinance (Cap. 405, Laws of Hong Kong), as well as the Securities and Futures Commission's ("SFC") Prevention of Money Laundering and Terrorist Financing Guidance Note. The proposed legislation seeks to address the deficiencies identified by the Financial Action Task Force following its evaluation of Hong Kong's AML regime in 2008.

The proposed legislation would also address a number of issues currently encountered by financial institutions in the course of complying with their existing AML obligations, including how to draw the fine distinction between (i) making genuine queries to the relevant person/entity suspected of engaging in money laundering and (ii) inadvertently "tipping off" that person (which is prohibited under the relevant legislation).

Key Legislative Proposals

The key legislative proposals are set out below, with our comments appearing thereafter in italics:

(a) *One set of rules* – All financial institutions would be subject to the same set of AML rules and regulations, with the relevant sector-specific regulator (e.g., the SFC for asset managers and the Hong Kong Monetary Authority for banks) being responsible for the supervision of compliance by the relevant financial intermediaries in that sector; all financial institutions would be liable for criminal as well as supervisory sanctions in cases of breach of the statutory requirements.

Under the current regulatory regime (which is activity-driven), certain entities may be subject to regulation by more than one regulator depending on the number of activities engaged in by that entity. Accordingly, the proposal to have a uniform set of AML rules

and regulations across the board, and across all sectors, may be difficult to implement in practice; apart from anything else, it requires attention to be paid to consistency in application of the AML rules and regulations across all sectors by the different regulators. Given the range of activities that may be engaged in, there have been counter-recommendations that there, instead, be a set of core principles and sector-specific guidelines to be adopted and implemented by the appropriate sector regulator.

(b) *Customer due diligence ("CDD") and record-keeping* – Under the proposed CDD measures, all financial institutions would be required to identify the beneficial owners of legal persons and arrangements, understand the control and ownership structure, and obtain information on the intended nature of business. CDD would need to take place both when a person becomes a client and on an ongoing basis, with simplified CDD applicable to low-risk cases and enhanced CDD being required for customers deemed to be high-risk.

Although there are existing obligations on financial institutions to obtain such information, these existing obligations are set out in various codes of practice/guidelines issued by the relevant regulators, and do not have the force of law (unlike the proposed legislation). However, the proposed legislation does not sufficiently address the prospect of financial institutions delegating their CDD checks to other service providers (as they are currently permitted to do in certain contexts).

(c) *Increased data retention period* – All financial institutions would be required to maintain identification data, account files, business correspondence, and records of both domestic and international transactions, for a period of six years *(an increase over the current five-year period required for SFC-licensed/registered entities to retain identification data).*

(d) *Supervisory powers of the regulatory authorities with respect to compliance* – The relevant authorities would be empowered to initiate an investigation if they have reasonable cause to believe that statutory obligations may have been breached. They would also be able to:

(i) enter the relevant financial institution's business premises to conduct inspections;

(ii) inspect and make copies, or record details, of any records or documents relating to the business, transaction or activity conducted by the financial institutions *(it has been suggested that this power should be exercised only in relation to CDD records rather than any records of the relevant entity);*

(iii) make inquiries of the financial institution requiring the person subject to an inquiry to verify by statutory declaration answers given;

(iv) enter into and search the relevant premises and seize documents/records and other items upon production of a warrant *(this power does* *not appear to necessarily be limited to only CDD information);*

(v) impose fines and other supervisory sanctions for breach of the statutory requirements, as well as prosecute offences summarily; and

(vi) share information obtained in their regulatory actions with overseas regulators.

(e) *Standards of liability* – Under the proposed legislation, an offence would be committed if there is a breach of the statutory CDD and/or record-keeping requirements under circumstances where the defendant cannot demonstrate a reasonable excuse. A member of the management of a financial institution would be personally liable for a breach by the financial institution, if committed with his/her consent or knowledge or based upon his/her recklessness. Only those persons who knowingly contravene the statutory obligations would be subject to criminal liability. If the offence is committed with intent to defraud, a more severe level of criminal sanction would be imposed.

There are concerns in the industry that criminal sanctions might be imposed upon a breach (albeit one with the necessary element of intent) of what are essentially compliance standards. This point has been fiercely debated again in the second round of government consultations which have just ended. It remains to be seen if the proposals survive this round of discussions.

Conclusion

The Hong Kong government aims to introduce a bill relating to the new legislation into the Hong Kong Legislative Council in the second quarter of 2010. While its efforts to remedy deficiencies in Hong Kong's current AML regime, and to bring the regime up to par with corresponding AML standards in other jurisdictions, are commendable, there are still a number of features of the proposed regime that appear to lack practicality and may even be fundamentally flawed.

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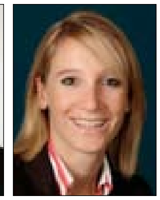
New German Regulatory Rules for Compensation Affecting Financial Institutions and Insurance Companies



by **Angelo Lercara** and **Nicole Alexander**

The recent financial crisis has stimulated a global regulatory response on a number of fronts. One area that has attracted the attention of regulators is that of performance-related bonuses that, some argue, have been a contributory factor to the recent crisis.

On 2 April 2009, the G-20 published the "Principles for Sound Compensation Practices" which was followed by the Financial Stability Board's ("FSB") "Principles for Sound Compensation Practices – Implementation Standards" of 25 September 2009 ("FSB Standards"). At the EU-level, a new directive on remuneration is being proposed.

In Germany, eight large German banks and the three largest German insurance companies signed self-commitment pledges to the FSB Standards in December 2009. In addition, the concepts outlined in the FSB Standards have now been implemented in Germany through two circulars published in December 2009 by the German Financial Services Supervisory Authority ("BaFin") (together the "BaFin Circulars" or "Circulars"). Finally, on 9 February 2010 the German Government published a draft bill with respect to compensation systems of financial institutions and insurance companies.

This article provides an overview of the content of the BaFin Circulars and analyzes how the German Government's draft bill will implement the Circulars and the FSB Standards.

The BaFin Circulars

The BaFin Circulars address compensation systems in relation to "financial institutions", as defined in the German Banking Act ("KWG") (the "Financial Institutions Circular") and "insurance companies", as defined in the Law on the Supervision of Insurance Undertakings ("VAG") (the "Insurance Circular").

The Circulars replace the compensation-related rules for the Minimum Requirements for Risk Management ("MaRisk") currently in force.

The Financial Institutions Circular

The Financial Institutions Circular sets out the requirements for compensation systems for financial services providers and credit institutions ("Institutions") (broadly, German licensed entities providing financial or banking services in Germany, as well as German branches of non-EU credit institutions (for example, from the United States), but excluding entities operating in Germany under the so-called "European passport").

The main aim of the Financial Institutions Circular is to avoid incentives that induce managing directors and employees to take disproportionally high risks.

The Financial Institutions Circular sets out general compensation requirements applicable to all employees, and specific requirements applicable to managing directors and employees who are able to incur high-risk positions.

"Compensation" for these purposes is broadly defined to include most monetary or non-monetary benefits, or benefits granted in connection with employment by an institution. However, benefits such as insurance and social insurance benefits, discounts or pension benefits that do not incentivise entering into risk positions are not treated as compensation for the purposes of the Financial Institutions Circular.

General Requirements

The main aim of the Financial Institutions Circular is to avoid incentives that induce managing directors and employees to take disproportionally high risks. Such incentives may arise, for example if: (i) there is a significant dependence on variable compensation (i.e., that which is discretionary or dependent on certain conditions); (ii) contractual redundancy payments are fully paid irrespective of whether an employee has positively contributed to the Institution's performance; or (iii) the compensation awarded to employees in "control" functions (such as risk management or compliance) creates conflicts of interest.

The Financial Institutions Circular also outlines requirements as to implementation and supervision of remuneration policies. In general, the Institution's executive board is responsible for establishing the compensation system for the employees, while the supervisory board is responsible for establishing the compensation for the executive board. Existing compensation arrangements are required to be reviewed on an annual basis by the supervisory board. The structure of the compensation system must be communicated to all employees, and must be built into the operating procedures of the Institution.

Specific Requirements

For managing directors and employees in a position to take high risks, special conditions apply. Such persons must be identified by the Institution based on a rigorous assessment by reference to objective criteria.

The specific requirements for such persons are primarily aimed at promoting sustainable development of the Institution. Accordingly, the Financial Institutions Circular provides that the variable and fixed elements of compensation must be appropriately balanced to avoid significant dependence on variable compensation, but may nonetheless provide an incentive to incur risk positions. Furthermore, the Financial Institutions Circular prohibits guaranteed bonus payments and only allows bonuses to be

awarded in exceptional cases as a one-off payment and at the start of an employment.

In a move towards the FSB Standards, the Financial Institutions Circular requires 40 percent of variable compensation to be deferred for three years. The Financial Institutions Circular also requires Institutions to take into account long-term sustainable performance of the Institution in determining levels of variable compensation.

In addition, there are requirements for control mechanisms; the specific requirements outlined above must be monitored and controlled by a compensation committee, and information regarding the compensation system (subject to certain conditions) must be published in detail on the Institution's website or another appropriate medium and be updated once a year.

Insurance Circular

The Insurance Circular imposes similar compensation requirements on entities in the insurance sector (broadly, certain insurance companies, reinsurance companies and pension funds) but with some modification to reflect the particular characteristics of that industry.

In particular, for insurance companies, insurance and social insurance benefits, discounts, or pension benefits are not exempted from the definition of "compensation".

Financial Conglomerates

Both Circulars apply to financial conglomerates at the group or conglomerate level so that each entity in a group is required to comply with only those provisions of the Circulars applicable to its business.

German Draft Bill

The German Government's 9 February 2010 draft bill on compensation systems of Institutions and insurance companies further develops the principles set out by the FSB Standards and the BaFin Circulars, and incorporates the requirements for Institutions into the KWG and for insurance companies into the VAG.

The draft bill introduces an obligation to provide for "appropriate, transparent compensation that is aimed at the sustainable development of the [Institution]" into the provisions that deal with the organizational duties of financial institutions and insurance companies. It is expected that the bill will broadly reflect the contents of the BaFin Circulars. Accordingly, it can be assumed that the principles laid out in the BaFin Circulars will remain the prevailing guidelines for the compensation systems of financial services providers, credit institutions and insurance companies in Germany.

In particular, for insurance companies, insurance and social insurance benefits, discounts, or pension benefits are not exempted from the definition of "compensation".

With respect to the enforcement of the new rules, BaFin will play an important role as the draft bill provides for rules that empower BaFin to prohibit or limit payment of variable remuneration if the requirements are not met.

Outlook

Given the connection between the content of the BaFin Circulars and the provisions set out in the draft legislation, it can be expected that the rules will find their way into the KWG and the VAG without material change from the principles set out in the BaFin Circulars.

It remains to be seen if the implementation of compensation regulations into the law brings about the desired effect of a more responsible risk taking by persons who are in a position to incur significant risks for an Institution or an insurance company.

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Amendments to Russian Securities Legislation Provide Definitions and Outline Terms and Conditions for Derivatives and Repo Transactions

 

by **Asiyat Kulterbaeva** and **Kirill Skopchevskiy**

On January 1, 2010, legislation titled "On Amendments to Part One and Part Two of the Tax Code of the Russian Federation and Certain Legal Acts of the Russian Federation" (the "Law") came into force, making amendments, among other provisions, to the existing securities legislation "On Securities Markets," dated 22 April 1996. An innovative piece of Russian legislation, the Law finally provides definitions for key securities market terms, including "financial instrument," "derivative," and "repo transaction." It should be noted that provisions in the Law detailing the specifics for the conclusion of derivatives contracts will not come into force until July 1, 2010.

An innovative piece of Russian legislation, the Law finally provides definitions for key securities market terms, including "financial instrument," "derivative," and "repo transaction."

Although the Law falls short of providing detailed terms and conditions for every aspect of derivatives and repo trading (and does not fill the legislative gap with respect to international derivatives and repos), it is nevertheless a very important development. It introduces long-awaited outline terms and conditions for derivatives transactions and will allow self-regulatory organizations and professional market participants to take the lead and further develop detailed standard terms based on the regulatory framework. The essential amendments to securities laws introduced by the Law are described in this article.

Financial Instruments and Derivatives

The Law has removed a significant gap in legislation by introducing the definition of a "financial instrument," which was a term often used but not properly defined in existing securities laws. Now, a "financial instrument" is defined as either a "security" or a "derivative." How the Law defines a "security" is relatively straightforward, but there are some issues to note under the new rules with regard to the definition of a "derivative."

The definition of a "derivative" in the Law includes well-known and commonly traded instruments such as standard swaps, forwards, futures and options linked to commodities, securities, FX and indices. It also covers more complex financial instruments such as inflation rate derivatives, interest rate derivatives, weather derivatives and credit default swaps. In respect of deliverable contracts, they must expressly state on their face that they are a derivatives contract

in order to qualify as such. Deliverable contracts with terms of delivery of less than three days (i.e., "spot," "today," and "tomorrow" delivery terms) are not included in the definition of a "derivative" and therefore fall outside the new regulatory framework.

The Law now also specifically provides for the possibility of counterparties entering into credit default swap transactions.

If the parties intend to enter into a number of derivative transactions, the terms and conditions which govern such transactions should be stipulated in either a separate framework agreement, and/or by stock exchange regulations (if relevant), and/or through the rules of a clearing house (if relevant). However, the Law specifically suggests that standard form documents may be developed by self-regulatory organizations. The Law suggests that such standard form documentation may contain terms relating to the grounds and procedure for termination of multiple derivative contracts between the same counterparties. Ideally, this will promote the development of Russian self-regulatory organizations and market-standard documentation analogous to the International Swaps and Derivatives Association (ISDA) and the standard form documents created by it.

The Law separately regulates derivatives entered into between "qualified investors" only. From July 1, 2010, derivatives designated for qualified investors only may be executed through brokers only (except where a derivative is obtained through a succession, conversion, reorganization, allocation of assets on a winding up, or otherwise through operation of law, or in other circumstances provided for by the Federal Service on Financial Markets of the Russian Federation). The term "qualified investor" includes domestic financial institutions, foreign financial organizations and individuals, and legal entities which meet certain criteria.

The Law now also specifically provides for the possibility of counterparties entering into credit default swap transactions. Market-traded credit default swaps may be entered into where (a) both parties to the transaction are admitted to trade on the Russian securities markets, (b) the "protection seller" (i.e., the party who sells protection against specified credit events such as a default, restructuring, or bankruptcy) is a qualified investor, and (c) the "protection buyer" is a legal entity other than an individual. Over-the-counter credit default swaps (i.e., contracts traded and privately negotiated directly between two parties, without going through an exchange or other intermediary) are allowed only when the protection seller is a credit organization, broker or dealer, and the protection buyer is a legal entity other than an individual.

It should be mentioned that the Law does not regulate transactions involving international derivatives. As a result, the existing Russian securities laws remain relevant, which state that where such international financial instruments are not admitted to public placement and circulation in Russia, they are available only to qualified investors and only through brokers.

The Law separately regulates derivatives entered into between "qualified investors" only.

It is also worth noting that Russian gambling laws have potential application to derivative transactions in Russia. However, it is not clear whether all derivatives will be regulated as a type of gambling transaction due to differences in the definition of "derivative" between the Law and the Russian Civil Code. Hopefully, this inconsistency will be clarified in the near future.

Repo Transactions

The Law provides a new definition for a "repo transaction" which replaces the former definition provided by the Russian Tax Code.

A repo transaction (or "sale-and-repurchase" transaction) is divided into two parts: under the first part, the seller sells securities to the buyer; under the second part, the seller repurchases the same (or fungible) securities back from the buyer within a stipulated term or on a specified date.

A natural person may only enter into a repo transaction if the counterparty is a broker, dealer, custodian, asset manager, or clearing or credit organization; otherwise he/she must engage a broker to transact the repo on his/her behalf.

The only repo transactions regulated under the Law relate to the sale and repurchase of (a) securities of a Russian issuer, (b) investment units of a unit investment fund managed by a Russian asset manager, and (c) shares or bonds of foreign issuers or securities of a foreign issuer which certify rights in relation to securities of Russian issuers.

The seller under a repo transaction is obliged to transfer securities free from any encumbrances, except when the buyer agrees to accept the encumbered securities. Where the seller fails to deliver free and clear title, and the buyer did not know and could not have known about the encumbrances, the buyer has the right to terminate the repo transaction.

The Law allows certain flexibility in the structuring of repo transactions in that re-hypothecation of the transferred securities by the buyer may be permitted or disallowed depending on the agreement of the parties. The parties may also provide for an obligation for one or either party to pay money or transfer back the securities where there is a specified change in the price of the securities.

The Law also provides certain grounds for the termination of a repo transaction due to the non-performance or improper performance by one or both of the parties of its obligations under the second part of the transaction.

As above in respect of derivative transactions, if the parties intend to enter into more than one repo transaction, the terms and conditions of such transactions may be stipulated in a framework agreement between the parties, the stock exchange regulations, or the rules of a clearing house. Key provisions, such as the requirements for the termination and settlement of multiple repo transactions, will be included in these as in the case of derivatives contracts as described above.

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FIN 48 – Accounting for Uncertain Tax Positions

(continued from page 7)

However, how well these proposed solutions operate will depend on the nature and duration of the tax liability. If, for example, a fund invests primarily in a particular jurisdiction and by virtue of a limitation period for tax claims is able to maintain a relatively static tax liability with a fairly constant turnover, it may be easier to implement an effective mechanism to allocate among investors. If, however, there is no limitation period available to “cap” the aggregate tax liability, the liability may continue to increase until it actually exceeds the fund’s gross asset value. In this scenario, an effective adjustment mechanism would be very difficult to achieve and concerns would focus on questions of solvency.

Even if the tax liability is relatively static, difficulties will still arise where a fund is required to accrue for liabilities that may never arise. For example, if a side pocket was used to reflect the uncertain position, if the liability was never actually crystallised or extinguished, the side pocket would theoretically persist in perpetuity. This would make it hard to ever return side pocket monies to investors without leaving the associated liability with the fund. An additional consequence is that it would be very difficult to wind up a fund which had recognised a tax liability which could not be extinguished.

To compound these issues, the accounting guidance requires that interest and penalties on unpaid tax should be taken into account and therefore, where limitation periods are not available, this will further increase the reserve that is required to be maintained.

Attribution and Reporting

As clarified by the ASU, FIN 48 specifically applies to pass-through (or tax transparent) entities. Therefore, entities which hitherto saw themselves as largely neutral from the tax perspective, will need to assess potential tax liabilities under FIN 48. The ASU provides in respect of pass-through entities, that attribution will be determined by the laws of the relevant taxing jurisdiction. Therefore, if a jurisdiction in which a fund had invested would attribute tax to the fund entity, then the fund would be required to recognise the tax position (even if in practice, the tax liability actually passed through to the investor).

If, however, the taxing jurisdiction would attribute the tax to the investor in a pass-through entity, the investor (and not the fund) would need to recognise the position.

Even where funds do not themselves report under U.S. GAAP, if they have U.S. investors or other investors reporting under U.S. GAAP, there is likely to be increasing pressure to provide information and reporting in order for those investors to ascertain their own uncertain tax positions.

K-1 Reporting

As a practical matter, these new requirements will probably only impact on K-1 reporting to investors/partners in two situations: (a) where partner capital accounts are determined in accordance with U.S. GAAP given the potential need to "mark to market" the accounts periodically; and (b) to meet any requests by investors who themselves report under U.S. GAAP for details of any tax exposures.

Analysis and Measurement

The existence of specific guidelines in FIN 48 and the prospect of the same under IAS will increase the work involved in analysing potential tax exposures in each jurisdiction in which the funds invest. In particular, advice in a number of jurisdictions may well be necessary in order to determine whether the more likely than not test is met. This will add to cost and resources involved, particularly where opinions from local counsel are required.

Mitigation Measures

As the tax positions reflected in U.S. GAAP accounts may (for some funds) now be reflected in their net asset values, it will be important to consider as an immediate matter what adjustments to the net asset value are appropriate and when these should be made. Again, these questions will depend on the facts, in particular the period during which a tax liability may arise. However, the prospect of a significant drop in net asset values creates the potential for a run on funds and also difficulties in ensuring equal treatment of investors. Therefore, these issues should be considered now, even for funds not using U.S. GAAP, to give the best chance of being able to manage and mitigate the potentially adverse consequences.

Some of the most significant tax liabilities for funds will be capital or withholding tax liabilities associated with their investments in certain jurisdictions. One potential means of mitigating these exposures is to trade through an entity with a substantial treaty network. This will help mitigate the impact in many cases (although it is worth noting that the ability to claim the treaty benefit will itself be a matter subject to analysis under FIN 48).

For jurisdictions where there is a potential tax liability, another option that might mitigate the tax exposure is to trade through swaps or other indirect means. This may enable the liability and the need for recognition to largely be eliminated. However, care would need to be taken to ensure that the swaps or other transactions are effected in such a way that the intended tax benefit is achieved and the transaction does not fall foul of tax avoidance or recharacterisation provisions.

The steps that can be taken and their effectiveness will also depend on the structure of the fund. For a master feeder with both pass-through and corporate entities, additional measures may be required to achieve the equivalent end results for all investors in the structure.

Conclusion

FIN 48 is an immediate reality for funds reporting under U.S. GAAP, but funds reporting under IAS may also be subject to similar rules in the future. Early analysis of potential tax exposures, particularly in potential problem jurisdictions, is highly recommended. In particular, if there is or may be such an exposure the extent of the potential liability could continue to grow unless steps are taken to mitigate the position.

Funds would also be well advised to start building flexibility into their organisational documents sooner rather than later to cater for the possibility of tax reserves being required.

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