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THE IMPACT OF US REGULATION ON ASIA

THE WORLD IS BECOMING SMALLER – ESPECIALLY WITHIN THE CONTEXT OF HEDGE FUND REGULATION. **KARL PAULSON EGBERT**, OF **DECHERT**, DISCUSSES HOW ASIA IS REACTING TO A WAVE OF NEW US HEDGE FUND REGULATION

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Many Asia-based hedge fund managers are at least 12 timezones away from Washington DC, but the reach of US regulation in Asia over the past year has been so pervasive that it has seemed like the US Securities and Exchange Commission (SEC), Commodities and Futures Trading Commission (CFTC) and Internal Revenue Service (IRS) have been in the office just next door. With the myriad of Dodd-Frank regulations that have become effective during this time, such Asian managers have had to become experts in an unprecedented array of US regulation.

Certain themes exist: the new rules focus on transparency and reporting in an attempt to give US regulators a bird's eye view of activities in the market. While the new regulations do not substantively regulate the type of investments that Asian managers may make, the complexity of these regulations, and the cost of complying with them, may drive (or, at least, be a factor to be considered in) some investment decisions – consider the negative impact that the Foreign Account Tax Compliance Act (Fatca) might have on US capital markets.

Another trend, exemplified by Fatca, is that regulators may lack the resources to actually police the markets, and compliance with the rules that they have promulgated, hence the reliance by the regulators on market participants to be the eyes, ears and even the muscle behind US laws.

> "NO US REGULATION HAS HAD GREATER SHORT-TERM IMPACT ON ASIAN FUND MANAGERS THAN THE US DERIVATIVES REGULATOR'S DECISION TO REQUIRE REGISTRATION OF MANY HEDGE FUNDS"

THE CFTC'S NEW DIRECTION

While Fatca will be the biggest game-changer, no US regulation has had greater short-term impact on Asian fund managers than the US derivatives regulator's decision to require registration of many hedge funds. Historically, fund managers had avoided CFTC oversight through the use of an exemption (known as Rule 4.13(a)(4)). But the CFTC faced extensive criticism after the global financial crisis and decided to re-assert its ability to regulate funds that use derivatives. The result was the rescission of Rule 4.13(a)(4) – managers must now find another exemption or register with the CFTC.

WHO IS AFFECTED?

All Asian hedge fund managers that (a) use derivatives; and (b) sell to US investors, have to ascertain whether CFTC registration is required. A de minimus exemption exists (Rule 4.13(a)(3)), but any hedge funds that hedge will find its terms difficult to comply with. In summary, a fund is exempt if:

(a) the fund's aggregate initial margins/ premia for covered derivatives do not exceed 5% of the fund's liquidation value; or

(b) the aggregate net notional value of such positions does not exceed 100% of the fund's liquidation value[1].

Covered derivatives include nearly all types of derivatives other than a handful of security-based options and swaps. Although Rule 4.13(a)(3) makes no mention of swaps, the CFTC recently adopted rules that clarify that swaps must be included in the above thresholds.

Some Asian fund managers might be able to take advantage of two other exemptions designed for offshore managers (Rules 30.4 and 30.5). But these exemptions are unwieldy and may not provide a long-term solution: the CFTC has stated that it will not adopt a blanket registration exemption for non-US managers until after it has reviewed the data provided by non-US managers who register. This process illustrates the CFTC's current thinking on the extraterritorial reach of its regulations.

Therefore, many managers will have to register with the CFTC by the end of 2012. The registration process can be time-intensive and distracting. As with many new regulatory burdens, the best approach is to start preparing for compliance early.

FORM PF

Another new requirement is Form PF, which provides US authorities with information on the systemic risk created by private funds. The form requires highly technical responses, and many funds have had to outsource compliance. Form PF will affect SEC-registered managers with more than $150m in private fund assets, but it is more disruptive to managers with more than $1.5bn in private fund assets: the latter must complete additional parts of Form PF and make quarterly filings.

These asset calculations can be challenging. AUMs include leverage, meaning that even relatively smaller funds may breach the $150m limit (not including separately managed accounts or funds that are not owned by or offered to US persons). As a result, a manager that is close to either the $150m or $1.5bn threshold may consider moving US investors into a single fund and welcoming large US investors into separately managed accounts where it makes sense to do so.

FATCA

Fund managers in Asia are still struggling to come to grips with the precise nature of their responsibilities under Fatca. The broad outline is clear: hedge funds will not be exempt from Fatca, so they should begin preparing for compliance in 2013.

For most managers, the task will primarily consist of searching for undeclared US investors among their existing client base and future investors. The primary tool for this process could be the US tax form W-8BEN. In the past, this form was used primarily to establish the non-US tax status of non-US investors. But the form was recently revised to take into account much of the information and investor representations required by Fatca. Hedge funds that use this form may not have to amend their subscription agreements substantially.

However, the form is complex and many investors may find it difficult to complete. In such situations, managers may nonetheless revise their subscription agreements or use software that makes the W-8BEN process somewhat easier.

Asian fund managers face one hurdle that many European managers do not: Asian governments have not been as enthusiastic about co-operating with Fatca. A number of European jurisdictions have agreed to assist the US in implementing Fatca; in return, funds in those jurisdictions are not required to enter into separate, individual agreements with the US IRS. In Asia, so far, only Japan has agreed to a framework of Fatca co-operation. Although negotiations between some other Asian jurisdictions and the US are ongoing, what will happen if these talks are not resolved prior to the Fatca compliance deadline? Asia-domiciled hedge funds may need to scramble then (or before) to enter into agreements directly with the IRS, which (we suggest) may be a logistical challenge.

CONCLUSION

The sheer volume of US regulatory change over the past year has been daunting, particularly in the manner in which it has impacted those Asia-based managers who have had little previous exposure to US regulation. Each of the above developments represents a major sea change from the respective US regulators. This, coupled with the heightened scrutiny on hedge fund managers by local Asian regulators themselves, has meant that Asian managers have had a significant compliance cost added to their books just in the past 12-18 months. However, there is, now perhaps, a light at the end of the tunnel: with many of Dodd-Frank's rules having been proposed or adopted. The worst may be over, leaving US lawmakers with somewhat less to do in the coming years. ■

"ASIAN FUND MANAGERS FACE ONE HURDLE THAT MANY EUROPEAN MANAGERS DO NOT: ASIAN GOVERNMENTS HAVE NOT BEEN AS ENTHUSIASTIC ABOUT CO-OPERATING WITH FATCA"

1 The text of the exclusion in Rule 4.13(a)(3) is as follows: a fund will be exempt if "At all times, the pool meets one or the other of the following tests with respect to its commodity interest positions, including positions in security futures products, whether entered into for bona fide hedging purposes or otherwise:

1A The aggregate initial margin, premiums, and required minimum security deposit for retail forex transactions (as defined in §5.1(m) of this chapter) required to establish such positions, determined at the time the most recent position was established, will not exceed 5% of the liquidation value of the pool's portfolio, after taking into account unrealised profits and unrealised losses on any such positions it has entered into; Provided, That in the case of an option that is in-the-money at the time of purchase, the in-the-money amount as defined in §190.01(x) of this chapter may be excluded in computing such 5%; or

1B The aggregate net notional value of such positions, determined at the time the most recent position was established, does not exceed 100% of the liquidation value of the pool's portfolio, after taking into account unrealised profits and unrealised losses on any such positions it has entered into.