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AIFMD

A Practical Comparison of Reporting Under AIFMD versus Form PF

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Europe's Alternative Investment Fund Managers Directive (AIFMD) is in full effect and the consolidated AIFMD reporting template – commonly referred to as "Annex IV" – is now final. Although some fund managers have already filed Annex IV, the vast majority will do so in January 2015, for the reporting period ending on December 31, 2014. There were efforts to harmonize Annex IV and Form PF and this update to "A Practical Guide to AIFMD Reporting for Non-E.U. Fund Managers: Reporting Under AIFMD versus Form PF," The Hedge Fund Law Report, Vol. 6, No. 20 (May 16, 2013), provides a useful side-by-side comparison of reporting under the two forms.

Firms should take note that even where this comparison highlights similarities between the two forms, there are still certain nuances that could trip up filers. For example, a nearly identical question asked on both forms – whether the fund cleared any transaction directly through a CCP – might be answered "no" on Form PF but "yes" on Annex IV because the forms apply a different interpretation of the term "directly". Filers should still review applicable guidance in order to correctly interpret each question and properly calculate the answers.

General Filing Obligations

Unlike fully authorized EEA managers that only need to file Annex IV with their home regulator, non-EEA managers that are relying on national private placement regimes to market their funds in Europe will be required to make an Annex IV filing with the local regulator in each jurisdiction in which they have registered to market a fund. Where different funds are marketed in different jurisdictions, the filings will need to be tailored accordingly. Indeed, there is a possibility that filings for the same fund will differ from jurisdiction to jurisdiction.

Structure of the Forms

Both forms include firm-level and fund-level sections. Form PF has seven sections, based on size and strategy of the manager and the funds. Hedge funds, liquidity funds, and private equity funds each have additional sections designated just for them.

Who Files Which Sections – Form PF

Section	Who Files
	All "private fund advisers"

1a	 Complete for the firm
1b	All “private fund advisers” Complete for each private fund
1c	All “private fund advisers” Complete for each hedge fund
2a	“Large hedge fund advisers” (i.e., ≥ $1.5 billion in “hedge fund AUM”) Complete for the firm, but only aggregating information about each hedge fund
2b	“Large hedge fund advisers” Complete for each “qualifying hedge fund” (i.e., ≥ $500 million NAV)
3	“Large liquidity fund advisers” (i.e., ≥ $ 1 billion in “combined money market and liquidity fund AUM”) Complete for each liquidity fund
4	“Large private equity advisers” (i.e., ≥ $2 billion in “private equity fund AUM”) Complete for each private equity fund

Annex IV was published as a spreadsheet, with four sections (i.e., four spreadsheet tabs). There are no separate sections for hedge funds, liquidity funds or private equity funds (although there are a few questions that are specific to fund strategy); instead, the form is presented in a “one size fits all” format.

The section titles in Annex IV correlate to certain articles in the AIFMD, which dictate the types of funds (AIFs) in respect of which firms (AIFMs) are to complete a particular section. The sections are titled AIFM file 24(1), AIF file 24(1), AIF file 24(2), and AIF file 24(4).

It should be noted that AIFM file 24(1) and AIF file 24(1) also apply to smaller AIFMs that are otherwise exempt from AIFMD under Article 3 of the Directive. These AIFMs are commonly referred to as “Registered AIFMs” (i.e., registered as exempt) while all other EEA-AIFMs are commonly referred to as “Authorized AIFMs.” Although generally exempt from the requirements of AIFMD, Registered AIFMs must still complete minimum reporting obligations. The two 24(1) sections are also titled “3(3)(d),” indicating that the sections are to be completed by Registered AIFMs.

Section 24(4) is to be completed in respect of AIFs that “employ leverage on a substantial basis,” which is when exposure as calculated according to the commitment method (which is described in more detail in the Commission Delegated Regulation implementing the AIFMD (the Regulation)) exceeds three times net asset value. Although an extra section seems cumbersome, in reality it should not be. Section 24(4) has just one question that is not already included in section 24(2) (the five largest sources of borrowed cash or securities (short positions)). AIFs in respect of which section 24(4) is completed may skip the duplicative questions listed in 24(2).

In addition to the Annex IV form, AIFMs must, on request, provide regulators with a list of the AIFs that they manage (pursuant to Article 24(3)).

Who Files Which Sections – Annex IV

Section	Who Files (EEA AIFMs)	Who Files (Non-EEA AIFMs)
AIFM file 24(1)	All AIFMs	All AIFMs
	Complete for the firm	Complete for the firm, but only aggregating AIFs marketed into jurisdiction
AIF file 24(1)	All AIFMs	All AIFMs
	Complete for each AIF managed	Complete for each AIF marketed into jurisdiction
AIF file 24(2)	All AIFMs, except Registered AIFMs	All AIFMs
	Complete for each EEA AIF managed and each AIF marketed in EEA	Complete for each AIF marketed into jurisdiction
AIF file 24(4)	All AIFMs, except Registered AIFMs	All AIFMs
	Complete for each AIF that is “substantially leveraged”	Complete for each AIF that is “substantially leveraged” and that is marketed into jurisdiction

“Marketing” and the Master-Feeder Issue

There is an anomaly in AIFMD with regard to the reporting of master-feeder fund structures. For Form PF, filers have the option of reporting on master and feeder funds separately or aggregating the information and submitting one filing on behalf of the master and feeder funds within the structure. For AIFMD, however, each fund must be reported on separately. The effects of this are different for EEA and non-EEA AIFMs.

For EEA AIFMs, this rule creates a problem for just one section of the form: section 24(2), which AIFMs are to complete for EEA funds and funds marketed in the EEA. In a master-feeder structure, generally it is the feeder fund that is marketed but it is the master fund that has holdings. Thus, for section 24(2) an EEA AIFM might find itself unable to answer much of the questions because it is filing the section for just the feeder fund.

For non-EEA AIFMs, the issue exists for the entire form, not just one section. Non-EEA AIFMs file Annex IV in accordance with Article 42 of the AIFMD, which instructs that non-EEA AIFMs file Annex IV only in respect of AIFs that are marketed into the EEA. Thus, for a master-feeder structure, Annex IV is filed for just the feeder fund.

ESMA recognized the problem but is unable to create reporting obligations beyond the scope set forth in the AIFMD. Member State regulators, however, may require additional information beyond the requirements of the AIFMD. On October 1, 2013 ESMA published an Opinion wherein it suggested that Member State regulators could require AIFMs to report information on a master fund if a feeder fund is being reported on and the funds have the same AIFM. The ESMA Opinion specifically addressed the master-feeder problem with regard to EEA AIFMs and the reporting of section 24(2), but did not address the master-feeder problem with regard to non-EEA AIFMs and the reporting of all sections of Annex IV. Regardless, individual Member State regulators have the authority to require such information from both EEA AIFMs and non-EEA AIFMs. As such, AIFMs must look to the Member States to which they are reporting to determine whether the reporting of the master fund is required for them.

Reporting Frequency and Deadlines

When determining the filing frequency and reporting deadlines for a firm or fund it is important to note that Form PF reporting is based on a firm's fiscal year while Annex IV reporting is based on the calendar year. Further, to determine the size of a firm or fund, a manager must calculate "Regulatory AUM" (RAUM) in accordance with instructions in Form PF and "Total AUM" in accordance with instructions in AIFMD. For Form PF, a firm's filing frequency is determined by the firm's size and strategy, with large hedge fund advisers and large liquidity fund advisers filing quarterly and all other firms filing annually. The size of the fund itself does not affect the filing frequency. Filing deadlines are likewise dictated by the firm's size and strategy. Large hedge fund advisers have a 60-day reporting deadline, large liquidity fund advisers have a 15-day reporting deadline, and all other advisers have a 120-day reporting deadline. A firm could have multiple filing frequencies and reporting deadlines. For example, a firm can be a large hedge fund adviser and a large private equity fund adviser, filing quarterly for certain sections of the form and annually for others.

Reporting frequency and deadlines – Form PF

Type	Frequency	Deadline
Large Hedge Fund Adviser (≥ $1.5 billion "hedge fund AUM")	Quarterly	60 days after fiscal quarter-end
Large Liquidity Fund Adviser (≥$1.0 billion "combined money market and liquidity fund AUM")	Quarterly	15 days after fiscal quarter-end
All other Private Fund Advisers (≥ $150 million RAUM) (including "large private equity advisers")	Annually	120 days after fiscal year-end

Reporting frequency for Annex IV is determined by the size of the firm as well as the size of the fund, whether a fund utilizes leverage, and the strategy of the fund. Accordingly, an AIFM might have multiple filing frequencies. For example, an AIFM might file on a half-yearly basis but have an AIF in respect of which it must file on a quarterly basis.

Reporting frequency and deadlines – Annex IV

Type	Frequency
AIFM managing a portfolio of AIFs > €1 billion AUM	Quarterly
AIFM managing a portfolio of AIFs ≤ € 1 billion AUM *but* > €100 million (including any assets acquired through the use of leverage) *or*	Half-yearly *but* Quarterly for each AIF whose AUM, including any assets acquired through the use of leverage, exceeds €500 million

> €500 million (if the portfolio of AIFs consists of AIFs that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF)	
AIFM managing a portfolio of AIFs *either* ≤ €100 million (including any assets acquired through the use of leverage) *or* ≤ €500 million (if the portfolio of AIFs consists of AIFs that are unleveraged and have no redemption rights exercisable during a period of 5 years following the date of initial investment in each AIF)	Annually
All AIFMs	Annually for each unleveraged AIF which, in accordance with its core investment policy, invests in non-listed companies and issuers in order to acquire control
Reporting Deadlines: The reporting deadline is the same for all AIFMs: "one month" after the end of the reporting period, except that for funds of funds the deadline is extended by 15 days.	

Instructions

Form PF comes with general instructions at the beginning of the form, some question-specific instructions throughout the form, and a glossary at the end of the form. The only other place a firm needs to look for guidance is the SEC Form PF FAQ webpage, which is periodically updated.

Annex IV, however, is presented in spreadsheet format and does not include a set of instructions or a glossary. Instead, a filer must take guidance from several sources of information, including the AIFMD (2011/61/EU), the Regulation (No 231/2013), the ESMA guidelines on reporting obligations under Articles 3(3)(d) and 24(1), (2) and (4) of the AIFMD, the ESMA IT technical guidance, and ESMA Q&A, as well as any Member State-specific rules, guidance and Q&A materials. This can be a difficult exercise because the questions on the form do not state which sources of information are applicable to that question – filers are simply expected to know. We expect this process to become more intuitive as filers get into their filing cycles.

Information Reported

Because the two forms are laid out differently, it is easier to compare the forms by subject matter rather than on a question-by-question basis. As mentioned in the introduction to this paper, this is a general comparison and it is incumbent upon filers to look at guidance for each question – including guidance from specific Member States – to interpret the questions and determine the correct calculations for each answer.

Assumptions - Both forms allow for assumptions, but Annex IV allows for assumptions at both the firm level and at the fund level. This is particularly useful for AIFMD because reporting at the fund level is decoupled from reporting at the firm level. Since a report in respect of a fund could be filed independently of the firm, a separate set of assumptions are needed at the fund level.

Information about the filing – Annex IV requires certain information about the filing itself at both the firm and the fund level, such as the reporting period, the Member State to which the AIFM is reporting, the version of the XML Schema Definition (XSD) used to generate the filing, the date and time the filing was created, and AIFM and AIF content codes and reporting codes which determine the sections to be filed. Form PF only asks for the filing type (*e.g.*, whether the submission is for an annual or quarterly filing). Information that determines which sections should be completed is already known by the regulator based on a firm's Form ADV filing.

Information about the firm – Both forms require the name and certain identifying codes of the firm, and both forms ask for the firm's AUM, although different calculations are used. For Form PF, RAUM is reported in U.S. Dollars and is broken out by strategy. It is essentially the asset side of the balance sheet, thus omitting short positions. For Annex IV, "Total AUM" is reported in Euro as well as the base currency of the firm. It is calculated using the value of all assets without deducting liabilities. Derivatives are converted into the equivalent position in the underlying assets of the derivative using specific conversion methodologies that are set forth in Annex II of the Regulations, and then the absolute value of the position is used. One item that Annex IV requires, but which is not necessary for Form PF, is a listing of the five principal markets in which the firm trades as well as the five principal instruments in which it trades. Finally, one requirement that Form PF has, but Annex IV does not, is the name and signature of an authorized representative of the firm.

Information about the fund – Both forms require the name and certain identifying codes of the fund, and both forms ask for the fund's AUM, applying the same calculations as used at the firm level. Fund-level identifying information that is required under Annex IV, but not Form PF, includes share class identification codes, a list of prime brokers for the fund, and the jurisdictions of the three main funding sources for the fund. While Form PF does not ask about the prime brokers of the fund, such information can be obtained from Form ADV. Both forms ask about investment strategy, but Form PF asks for investment strategy of just hedge funds, while Annex IV requires a breakdown of strategy for funds that have primarily hedge fund, private equity, real estate, funds of funds, or "other" strategies. Additionally, there is some variation between the hedge fund strategy types provided by each form.

Instruments traded and individual exposures – Annex IV asks for main instruments in which the fund trades, principal exposures by asset type, and principal markets where the fund trades. Both forms require the reporting of portfolio concentration, exposure by asset type, turnover, and exposure by geography.

Market Risk – Both forms have questions about market risk. However, Form PF only requires the reporting of VaR if it is already regularly calculated for the fund, and then provides other risk metrics and market factors for a filer to designate as relevant. Annex IV requires the reporting of certain risk metrics, such as "Net Equity Delta," "Net DV01," and "Net CS01." Annex IV also requires expected annual investment return/IRR in normal market conditions.

Counterparty Risk – Both forms require information on trading and clearing mechanisms, top five counterparty exposures, collateral for counterparty exposure, rehypothecation of collateral, and direct clearing through a CCP. As with other questions, these questions require a careful reading to understand the nuances between the two forms.

Liquidity Risk (Portfolio Liquidity, Financing Liquidity, and Investor Liquidity) – Both forms require information on portfolio liquidity, financing liquidity, and investor liquidity, including the value of unencumbered cash, and borrowings and cash financing available to the fund. Both forms require information on investor liquidity and restrictions placed on investor redemptions, as well as information on investor concentration broken out by investor group—although the group categories are different. Form PF asks about side pockets, while Annex IV asks additional questions about special arrangements (which includes side pockets).

Borrowing and exposure risk – Form PF requires borrowing data as of the end of each month in the reporting period, but Annex IV requires data as of the end of the reporting period. Annex IV asks about securities borrowed to short and the five largest sources of borrowed cash or securities (short positions). Annex IV also asks for leverage – calculated via gross and commitment methods as set forth in the Regulation – and Form PF does not.

Operational and other risk aspects – Both forms ask for the number of open positions and performance. Annex IV asks for change in NAV and a monthly reporting of subscriptions/redemptions. Finally, Annex IV asks for a reporting of stress tests (to the extent they are required to be conducted). Form PF does not have such a requirement, but does require the reporting of market factors if relevant to the portfolio.

Summary

Although there is much overlap between Annex IV and Form PF, and much of the same raw data can be used to calculate answers for many of the questions on both forms (approximately ninety percent of the raw data is the same), there are many distinctions and filers must tread carefully when calculating answers. AIFMs reporting into more than one jurisdiction must pay particular attention, as local guidance from Member States can vary and will affect each filing of the AIFM.

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David Vaughan is a partner in Dechert LLP's Washington, D.C. office and has been practicing in the private fund space for well over two decades, including serving for two years as the senior private fund policy adviser in the SEC's Division of Investment Management, advising on all aspects of legal and regulatory policy related to private funds. During that period, he played a leading role in advising on Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the rules implementing those provisions, the Volcker Rule, and the AIFMD, among other things. Mr. Vaughan works with hedge funds, private equity funds, venture capital funds and unregistered traditional funds. He represents managers with respect to fund formation, distribution and compliance issues, as well as enforcement matters. He has also represented both insurance companies and fund sponsors with respect to privately placed and offshore variable insurance products.

Chris Gardner is a partner in Dechert LLP's London office, with a practice which focuses on the structuring and establishment of private funds domiciled in a range of onshore and offshore jurisdictions and across a range of asset classes, including hedge, hybrid, debt, buyout, listed equity, real estate, renewable energy and agriculture/timber funds. He also advises on M&A transactions in the financial services sector, on the spin outs and establishment of new asset management businesses and on the sale and purchase of fund interests, as well as providing advice on portfolio company corporate and commercial matters.

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OFFICE SHARING

Identifying and Mitigating the Chief Legal, Regulatory and Operational Risks in Hedge Fund Manager Office Sharing Arrangements (Part Three of Three)

By Zoe McKelvey

On the positive side, sharing office space can save hedge fund managers (especially startup managers) money, increase efficiency and facilitate legal idea sharing. On the negative side, sharing office space can increase regulatory and operating risk. The first article in this three-part series detailed the main benefits of office sharing. The second article detailed the main risks and how to mitigate them. This article, the last in the series, discusses subadvisor, subtenant and contract arrangements; allocation of hedge fund manager real estate costs; prime broker and "hedge fund hotel" arrangements; and how to handle office sharing arrangements during on-site due diligence visits by institutional investors.

Subadvisor, Subtenant and Contract Arrangements

Office sharing arrangements typically fall within one of three structures: those in which the sharing managers are affiliated, often as adviser and subadvisor; those in which the sharing managers are unaffiliated; and those in which multiple managers receive real estate and related services from a single service provider.

With respect to the first category of arrangement, Dechert LLP partner George Mazin noted that a subadvisor typically "would get a portion of the management fee and incentive fee on the portion of the portfolio advised by the subadvisor" and presumably would pay a market rent to the adviser for the shared space. Importantly, the rental agreement and the subadvisory agreement would typically be separate agreements. In other words, rent would not ordinarily be netted out of subadvisory fees payable by the adviser to the subadvisor.

With respect to the second category of arrangement – two or more unaffiliated manager sharing a single space – Paul Hastings partner Mitchell Nichter noted, "I've seen situations in which established managers have excess space in a long-term lease that they cannot utilize, so they sublet that space, either to a widget maker or another money manager. In that situation, the sublessor is at least looking to cover its rental and embedded rental costs. The rent charged to the sublessee is typically a percentage of the sublessor's overall rent. Depending on how the lease is structured, there could be a similar percentage charge for utilities. The sublease should also cover tenant improvements and mechanics and cost allocations for any physical segregation of space." In short, when multiple unaffiliated managers share office space, the arrangement looks like a classic sublease arrangement.

Finally, Bob Guilbert, Managing Director of Marketing and Products at Eze Castle Integration, discussed a structure in which multiple hedge fund managers receive office space and related services from a single service provider. This kind of structure or nearby variants on it include hedge fund incubation spaces, offices in which multiple seedees of the same seedor operate, offices maintain by prime brokers specifically for this purpose and so-called hedge fund hotels. In such situations, costs to the management companies are typically determined by square footage used and volume of infrastructure consumed (e.g., IT or technology resources used per month); the former is a fixed cost (subject to physical expansion), and the latter is a variable cost. As in the first structure discussed above (involving advisers sharing space with subadvisors), the providers of real estate and related services to multiple hedge fund managers in a single space typically bill those managers separately for the real estate services, even when they have other contracts with the managers. For example, if a manager's prime broker has set the manager up with office space (shared with other managers), the manager will likely have a real estate agreement with the prime broker and a separate prime brokerage agreement with the prime broker. See "Prime Brokerage Arrangements from the Hedge Fund Manager Perspective: Financing Structures; Trends in Services; Counterparty Risk; and Negotiating Agreements," The Hedge Fund Law Report, Vol. 6, No. 2 (Jan. 10, 2013).

Allocation of Real Estate Costs

The strong presumption in the hedge fund industry is that real estate related costs are a management company rather than a fund expense. As Nichter explained, "The management company, not the fund, usually bears the cost of the space. This cost is typically considered part of the management company's overhead, though there might be instances where a manager wants to be aggressive. For example, if a manager is associated with a hedge fund hotel or a prime broker that might be willing to essentially reimburse the manager for non-research or brokerage expenses outside of the Section 28 safe harbor for soft dollars, then the manager may pay for its space through a soft dollar arrangement with the broker. However, in my client base, that's not very common." On U.S. soft dollar arrangements, see "Forum Identifies Best Practices for Hedge Fund Managers Regarding Best Execution, Soft Dollars, Principal Trades, Agency Cross Trades, Cross Trades and Trade Errors," The Hedge Fund Law Report, Vol. 7, No. 10 (Mar. 13, 2014). On U.K. "softing," see "U.K. Financial Conduct Authority Clarifies Whether Hedge Fund Managers May Use Dealing Commissions to Pay for Substantive Research or Corporate Access," The Hedge Fund Law Report, Vol. 7, No. 28 (Jul. 24, 2014).

Seward & Kissel attorney David R. Mulle concurred on this point: "You'd need very specific disclosure to charge the cost of the space to the fund, and no matter what you put in your governing documents, the SEC would probably find it not adequate." See generally "Battle-Tested Best Practices for Private Fund Expense Allocations," The Hedge Fund Law Report, Vol. 7, No. 38 (Oct. 10, 2014).

Prime Brokers

As indicated above, prime brokers sometimes lease office space to hedge fund manager customers. If such a lease is at market rates, there is no conflict, fiduciary duty, disclosure or similar regulatory issue raised by the arrangement. However, if a prime broker leases space to a hedge fund manager customer at below market rates, the typical assumption on the part of regulators and institutional investors is that the difference between a market rent and the rent paid by the manager constitutes soft dollar credits given by the prime broker to the manager. In turn, such an arrangement raises the presumption – rebuttable, but difficult to rebut – that the manager is a customer of the broker because the broker is offering the manager below market rent rather than because the broker is offering the manager best execution for its funds.

As Nichter explained, if a manager's lease from a prime broker "involves below-market arrangements, then those arrangements are usually presumed to involve some type of soft dollars and would need to be fully disclosed to fund investors and advisory clients. That type of disclosure is apt to turn certain institutional investors off from the manager. Such an arrangement is seen to be a blatant form of conflict of interest." Nichter continued: "If you fully disclose a material conflict of interest to a client, then that conflict no longer constitutes a breach of fiduciary duty. On the other hand, the purpose of the disclosure is to let the client know that you have a conflict and oftentimes, institutional clients that are fiduciaries themselves, such as pension plans, do not want to have anything to do with such conflicts. They want a manager that's going to be acting in their sole best interest. They want a manager that's going to choose a broker without regard to the other value that the broker might provide to the manager personally." Such investors, Nichter said, are "simply not willing to do business with managers" whose business practices involve such conflicts.

As a consequence of the institutionalization of the hedge fund investor base and a concomitant closer scrutiny of soft dollars, it is not as common today for hedge fund managers to rent office space from prime brokers as it was ten years ago. Nichter made this point, and Seward's Mulle seconded it. "Both prime brokers and hedge fund managers are more cognizant of potential conflicts than they were ten years ago," Mulle said. "There's also a perception among managers that when the SEC comes in to do an examination, they are going to pay particular attention to an office space sharing arrangement." See "Usable Lessons and Proven Survival Techniques from the Hedge Fund Examination Trenches," The Hedge Fund Law Report, Vol. 7, No. 38 (Oct. 10, 2014).

In addition to federal scrutiny of office sharing arrangements, state regulators may also look askance on the practice. In 2010, the Massachusetts Securities Division imposed fines on UBS Securities for failing to disclose to investors that it had offered hedge fund managers below-market office space in exchange for hedge fund prime brokerage business – a "hedge fund hotel" arrangement. See, "UBS Settles Claims that it Offered Hedge Fund Manager Customers of its Prime Brokerage Business Below-Market Office Rental Deals Without Adequate Disclosure," The Hedge Fund Law Report, Vol. 3, No. 47 (Dec. 3, 2010). Years earlier, ABN Amro (which UBS acquired in 2003) had been offering high-end office space and other services at discounted rates to recruit hedge fund start-ups to its prime brokerage business, without disclosing the details of those relationships to investors. In addition to UBS paying a $100,000 fine, the settlement required UBS to institute a policy ensuring that each investment adviser with a prime brokerage agreement with UBS and who licensed office space from UBS in Massachusetts provide written disclosure to its clients on that relationship, including the fact that it "might be a factor" considered by the adviser "when choosing UBS to effectuate securities transactions on behalf of its clients."

Negotiating On-Site Due Diligence Visits from Institutional Investors

Yet another challenge posed by office sharing arrangements is how to receive and handle on-site due diligence visits from institutional investors. Like regulators, investors may be skeptical about a manager's ability to maintain confidentiality and mitigate the other regulatory and operating risks identified earlier in the series. According to Nichter, the best strategy in such cases is to address the office sharing issue directly. Managers, he suggested, should point out the different facilities and barriers in place, highlighting the separation of physical space and technological systems. Managers should also emphasize precautions taken with respect to privacy of investor data and trading information. In short, during diligence visits, managers should address sharing as if they were asked about it by the SEC in the course of an examination: directly, forthrightly and with a coherent explanation of how risks have been diagnosed and handled. The time to do so credibly, of course, is before a diligence visit or an SEC examination.

MARKETING

K&L Gates Partners Offer Practical Guidance for Hedge Fund Managers on Raising Capital in Australia, the Middle East and Asia

By Vincent Pitaro

Pension funds and sovereign wealth funds are important potential sources of capital for hedge fund managers. Australia and Japan have about $1.7 trillion and $1.2 trillion in pension assets, respectively, while the sovereign wealth funds of Middle East nations hold another $1.8 trillion. The Chinese market has huge potential as well. In that regard, a recent presentation by international law firm K&L Gates LLP offered a comprehensive overview of the regulatory regimes and marketing requirements that affect fund managers seeking capital in Australia, the Middle East, Japan, China, Hong Kong and Singapore. The program, entitled "Raising Private Fund Assets in the Global Markets – Focus on Asia, Australia, and the Middle East," was moderated by K&L Gates partner Cary J. Meer. The other speakers were her partners Natalie R. Boyd, Elizabeth A. Gray, Betsy-Ann Howe, Tsuguhito Omagari and Choo Lye Tan. For a similar global regulatory roundup, see "KPMG Report Highlights Key Developments in Hedge Fund Regulation in the Americas, the Asia-Pacific Region, Europe, South Africa and the Middle East," The Hedge Fund Law Report, Vol. 7, No. 33 (Sep. 4, 2014). For a discussion of regional "passport" initiatives that may facilitate marketing of funds in Asia and Australia, see "How Can U.S. Hedge Fund Managers Use Passport and Mutual Recognition Initiatives to Market to Investors in Asia?," The Hedge Fund Law Report, Vol. 7, No. 27 (Jul. 18, 2014).

Australia

Gray said that the Australian investment management industry, with $2.2 trillion in assets, is the third largest in the world after the U.S. and Luxembourg. The main reason is Australia's mandatory pension system, referred to as "superannuation," which takes in 9% of every person's income; she said the contribution rate was recently increased to 12%. With $1.7 trillion in assets, the system is larger than the Australian economy and is expected to quadruple in size in the next 18 years. Australia also has one sovereign wealth fund (SWF) with about $90 billion in assets. Gray added that the pension system is overweight Australian equities and Australian property, so more money will have to be invested offshore. In that regard, growth is expected in allocations to offshore fixed income products, as well as offshore infrastructure and real estate. As of June 2012, Australian pension funds had $800 billion invested offshore or with non-resident managers. Despite recent growth in funds of funds, a pull-back is expected. Australia has had many boutique asset managers, but many more large global managers are entering market. Australia's pension funds are divided into three main segments: 42% of its "super" (pension) funds are in not-for-profit industry, public sector and corporate funds; 27.4% are in for-profit retail funds (owned by banks or insurance companies); and 30.6% are in self-managed funds that are typically established by high net worth (HNW) individuals. The self-managed segment is expected to grow significantly over the next five years; many advisers forget to consider this segment.

Gray said that, though the asset management industry is highly regulated, Australia still has a "very open regulatory environment." The primary regulator of financial services and products is the Australian Securities and Investments Commission. The most important law is the Corporations Act. Regulations govern licensing, disclosure, compliance, operations and reporting:

- *Financial Services License (FSL).* An FSL is needed to provide services in Australia. However, an SEC-regulated adviser dealing with institutional clients does not need an FSL license; such an adviser must apply for an exemption, which is available through a simple, inexpensive process. She said that, as an adviser's services expand, it may be preferable to establish an Australia-based subsidiary that obtains an FSL license. Gray said that exemptions from licensing requirements are evergreen as long as the entity continues to satisfy the requisite conditions.
- *Fund Setup and Structure*. There is an eight page disclosure document for traditional fund products other than hedge funds or real estate investment trusts (REITs). Offshore managers find the document very challenging because of its condensed format. Managers of REITs and certain other vehicles must meet special requirements when purchasing local assets. Funds are subject to detailed compliance and reporting requirements. Fund structure is also unique because there are no corporate collective investment vehicles, limited partnerships (LPs) or limited liability companies (LLCs). Managers use unit trusts that are subject to state-based trust law, which complicates fund setup for offshore managers. Such managers usually start with an outsourced trust operation using an established local manager. After an offshore manager has a few funds, it is more likely to bring management in-house.

Gray said that pension funds must report to regulators, who release fee and performance information to the public. Consequently, Australian funds face significant fee pressure and competition; offshore managers cannot expect to charge standard fees. She added that five key asset consultants represent about 85% of the pension market; it is essential for offshore managers to work with them and build relationships with them. See "[Getting to Know the Gatekeepers: How Hedge Fund Managers Can Interface with Investment Consultants to Access Institutional Capital (Part Two of Two)]()," The Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013). Gray noted that there are now over 300 Australian pension funds and that regulators, concerned that there are too many funds, apparently want to reduce that number to around 100. A manager entering the market should investigate which funds are growing and avoid those likely to be taken over. She added that larger funds are bringing management of some assets in-house as they grow, especially local investments. She cautioned that if a manager decides to enter the Australian market, it should commit to it for the long-term: A manager who leaves and tries to re-enter will not be accepted back easily.

Tax Considerations

Howe said that Australian pension funds take four important considerations into account when making investment decisions:

- They avoid foreign tax filings, especially U.S. filings.
- They try to minimize tax leakage: Pensions receive preferential tax treatment (a 15% regular rate, and 7.5% rate on capital gains); if they pay a higher rate in a foreign jurisdiction, the excess tax payment may be lost.
- They avoid taxation on an "attribution" basis: Investments in controlled foreign companies may be taxed on undistributed income.
- They seek investments eligible for capital gains tax treatment.

Howe said that all investment vehicles, including LPs, are treated as companies in Australia. Thus, investments in foreign LPs may fall within the controlled foreign company regime, and their distributions may be treated as dividends. That regime is generally acceptable to Australian investors; however, investors are averse to taxation on unrealized gains in a portfolio. She said that new regulations will allow some foreign hybrid vehicles, such as LLCs, to be treated as pass-through vehicles; to be eligible, a vehicle must be taxed as an "entity" in its home jurisdiction. The type of vehicle also affects the availability of foreign tax credits: A non-transparent vehicle will not be able to use foreign tax credits. As an example, Howe explained that a Cayman fund would not qualify as a preferred foreign hybrid vehicle because it is not subject to tax in the Caymans; consequently if five or fewer Australian investors owned 50% or more of a Cayman fund, the fund would be deemed a controlled foreign corporation, and its income would be subject to taxation on an attribution basis. In addition, there is generally no flow-through of foreign tax credits for Cayman funds, but there are case-by-case exemptions. Finally, Howe noted that an Australian unit trust is the vehicle of choice for foreign investments, as it is the only available tax-transparent entity. A U.S. fund would typically invest in an Australian unit trust that serves as a feeder fund to a pension fund. See "Key Hedge Fund Tax Developments in the U.K., the European Union, Ireland, Germany, Spain, Australia, India and Puerto Rico," The Hedge Fund Law Report, Vol. 6, No. 26 (Jun. 27, 2013).

The Middle East

Boyd said that the Gulf Cooperation Council (GCC) was created in 1981 as a political and economic union, but not a monetary union. It includes Saudi Arabia, Kuwait, Oman, the United Arab Emirates (UAE), Qatar and Bahrain. She said there is little opportunity for foreign investment in the Middle East outside of the GCC. The GCC has more than one third of the world's sovereign wealth funds (SWFs), and over $1.8 trillion in assets. The three largest SWFs are the Abu Dhabi Investment Authority ($773 billion), the Saudi Arabian Monetary Agency ($533 billion) and the Kuwait Investment Authority ($296 billion). Wealth in the GCC has continued to grow despite recent political turmoil in the region. Boyd noted that, with the exception of the Qatar Investment Authority ($100 billion), other GCC SWFs are now looking internally for investment opportunities. See "Why and How Do Middle Eastern Sovereign Wealth Funds, Pension Funds and High Net Worth Individuals Invest in Private Funds?," The Hedge Fund Law Report, Vol. 6, No. 23 (Jun. 6, 2013).

Boyd added that regional regulations are expected to tighten in line with worldwide trends. There is no license passporting across the GCC. In addition, the "tolerated practice" approach, under which occasional fly-in, fly-out trips for marketing are not challenged, is changing. Such activities are no longer tolerated in Saudi Arabia, the UAE or, with regard to collective investment vehicles, Bahrain. An adviser can target clients in other countries if it does not have a physical presence and is "relatively discrete": Visits to the country should be limited; and the adviser may offer general information, but not seminars, offering documents or other specific marketing materials. Specific materials should be sent from outside the jurisdiction; and documents should be executed, and funds transferred, from outside the jurisdiction.

Boyd said that the Dubai International Financial Centre (DIFC) has a preferred status: It is treated as an offshore free zone, has no corporate taxes and has its own common law. However, there is no licensing or passporting between the DIFC and the rest of the GCC. Consequently, a firm cannot set up a branch or representative office in the DIFC and then market across the region. "Tolerated practice" is still accepted in the DIFC. The DIFC has only nine domestic funds. It recently established a qualified investor fund regime aimed at qualified HNW individuals that is less heavily regulated than other types of funds: Offerings must be private placements with a minimum of 50 unit holders; there must be a minimum subscription of $500,000. She noted that firms established in the DIFC are relying on reverse solicitation as a means of marketing.

Boyd said that the key Emirates in the funds industry are Abu Dhabi and Dubai; key regulators are the UAE Central Bank and the Emirati Security and Commodities Authority (ESCA). As of 2012, tolerated practices were completely prohibited. To market funds there, an adviser must have a licensed presence outside of the DIFC, either through a stand-alone company, a branch of a foreign-regulated company, or a representative office. A representative office may only be used for marketing; clients cannot be on-boarded there. A local promoter must register with ESCA and have its prospectus approved by ESCA. There are exemptions for marketing to government-owned institutions, dealing with foreign accounts and reverse solicitation. An adviser may have general discussions with non-governmental institutions, but a prospect cannot contact the firm within the country about investing. For a more detailed look at the UAW from Boyd, see "United Arab Emirates Implements Licensing Regime for Firms Providing Investment Management Services," The Hedge Fund Law Report, Vol. 7, No. 20 (May 23, 2014).

Boyd said that Saudi Arabia has the most restrictive regulations. Unless an exemption is available, foreign funds must register and act via an "authorized person" licensed by its Capital Market Authority (CMA). There are no public offerings of foreign funds. The CMA has issued stern warnings against offering funds without complying with the regime. She noted that the CMA may "lighten" the regulation, but that the authorized person requirement will remain.

Boyd said there are sovereign immunity issues across the region, so it may be difficult to enforce agreements against SWFs. Meer noted that governing documents often limit GCC funds to Sharia-compliant investments, so it may be hard to figure out what investments a GCC fund is allowed to do. Boyd said that the onus is on the Islamic investor to buy units only in funds that are Sharia-compliant. See "The 'New-Age' Sukuk Market: How Investors Can Profit While Safeguarding Against Legal Risk," The Hedge Fund Law Report, Vol. 4, No. 33 (Sep. 22, 2011).

Japan

Omagari explained that two primary laws regulate marketing to Japanese investors: The Financial Instrument and Exchange Act (FIEA) covers private placements and licensing of marketing and investment management. The Investment Trust and Investment Corporation Act (ITICA) governs the offering of interests in foreign investment trusts and corporations. Omagari said that rules may vary depending on whether a foreign fund is a corporate fund; and investment trust; or another collective vehicle, such as an LP or LLC. Liquid fund interests (Type 1), such as corporate shares and unit investment trusts, are treated differently from other securities (Type 2), including LP and LLC interests.

Offering Requirements Under the FIEA

The rules for private placements under the FIEA depend on the type of securities offered. A private placement of Type 1 securities can be to either 49 or fewer *offerees* or to Qualified Institutional Investors (QIIs). A private placement of Type 2 securities is available if there are fewer than 500 *investors* (i.e., no limit on offerees).

Offerings Requirements Under the ITICA

Omagari explained that foreign investment trusts and foreign investment corporations must notify the regulator before marketing a private placement. The main offering document must be in Japanese; supporting documents may be filed in English. Meer said that the process can take around three weeks; translation is the longest part. Omagari said that there is no waiting period and no filing fee; marketing may commence when the filing receipt is issued. A firm must update its filings as needed. He added that a foreign investment trust (but not a foreign investment corporation) must also file an investment management report at the end of each calculation period (except on offerings to QIIs).

Licensing Under FIEA

Omagari said that a different Financial Instrument Dealing License is required for marketing Type 1 versus Type 2 securities. There are two types of exemptions. The first is for “self-solicitation” by a corporate issuer (but not trusts, LPs or LLCs). Second, a foreign broker-dealer that is licensed to market in a foreign jurisdiction may market into Japan to (1) a licensed Japanese broker (whether from inside or outside Japan) or (2) to certain professional investors (but only from outside Japan and not directly to Japanese pension funds). Regulators have not provided clear guidance as to what constitutes marketing in Japan. A foreign broker-dealer cannot have a business base in Japan, but may be able to come to Japan on short-term business trips to meet professional investors.

Investment Management Licenses Under the FIEA

The general partner (GP) of an LP (or managing member of an LLC) must have an investment management license. A manager of a foreign investment trust or foreign investment corporation is not required to have a license.

Marketing Exemptions for Foreign LPs and LLCs

A GP or managing member of an LP or LLC may pursue “self-solicitation” (marketing its own fund interests) so long as there is at least one QII and 49 or fewer non-QII Japanese investors; the offering document must set forth offering restrictions and the manager must file a “Form 20” in advance. A fund's investment manager has two available exemptions: The first is available if there is at least one QII and 49 or fewer non-QII Japanese investors, and a Form 20 is filed in advance. The second is available if all Japanese investors are QIIs, there are fewer than 10 QIIs in total, and those QIIs make less than 30% of total fund contributions.

Japanese Pension Regime

Omagari said that all Japanese nationals must participate in a public or private pension fund. Japan's "National" and "Employees" public pension plans are managed by the Government Pension Investment Fund, which delegates management of all assets (other than passive investments in domestic bonds) to banks and investment managers. Public pensions have ¥127 trillion in assets. Although private pensions may be self-managed under certain circumstances, they are typically managed through trust agreements with trust banks, life insurance and outside investment managers.

Hong Kong, Singapore and the People's Republic of China

Tan said that Hong Kong and Singapore are seen as gateways to the region. Hong Kong is the only practical gateway into the People's Republic of China (PRC). Singapore is still part of the British Commonwealth. Both still use the British company regime and common law. Unlike Hong Kong and Singapore, there is no registration or license available in the PRC that permits marketing by foreign advisers. Moreover, in the PRC, if an activity is not covered by regulation, a firm must assume that it is prohibited. Consequently, marketing directly into the PRC is generally prohibited; Tan noted that firms do market discretely into the PRC through lunches, infrequent visits and other informal means. Unlike the Middle East, however, there are no tolerated practices; firms solicit business at their peril. Tan added that the PRC is known for introducing "game-changing" legislation without any advance notice, such as the new Stock Connect program, which is now going live and will permit cross-border trading of shares. She added that the PRC adopted a mutual recognition regime with Hong Kong last year and plans for the Renminbi to be restriction-free by 2015.

Tan explained that Hong Kong and Singapore require licenses for marketing funds, but that exemptions are available for marketing to institutional investors. In Hong Kong, an exemption is only available for a person acting in a principal capacity, not someone acting through a paid agent; however, regulators have agreed that an investment adviser that sets up a fund would be considered a principal for purposes of the exemption. Both jurisdictions also have registration requirements for the investment units being offered. She discussed similarities between the Hong Kong and Singapore fund environments:

- Set-up logistics should not be a driving force: Costs are comparable in both jurisdictions, and the time frame in both is about 12-15 weeks.
- Both have safe harbor exemptions from prospectus requirements for certain small offerings, offerings with specified minimum subscriptions and offerings to professional investors. She cautioned that there is a difference between licensing for marketing activities and the registration of offering materials; being exempt from one does not mean that a firm is exempt from the other.
- Both have minimum local capital and liquidity requirements. How a firm may satisfy those requirements depends in part on the type of investors it has.

- Tax rates are comparable. In Hong Kong, an investment adviser is typically incorporated offshore for tax reasons.

Tan said that in Hong Kong the key licenses that foreign advisers may need are for dealing in securities (Type 1), advising on securities (Type 4) and asset management (Type 9). Temporary or provisional licenses may be available. Once an adviser has those licenses it still needs to comply with prospectus requirements. Occasional visits to Hong Kong may not trigger a licensing requirement. Licensing in both Hong Kong and Singapore is straightforward, but the documentation process is "very painful," and includes identification of a firm's beneficial owners. Authorization of collective investment schemes is required in Hong Kong only for retail schemes (offerings to more than 50 persons), which are treated like IPOs. Singapore's rules and regulators generally follow English principles. For a detailed overview of the Hong Kong and Singapore markets, see The Hedge Fund Law Report's four-part series, "Primary Regulatory and Business Considerations When Opening a Hedge Fund Management Company Office in Asia," Part One of Four, Part Two of Four, Part Three of Four and Part Four of Four.

As indicated above, the PRC has no specific laws on marketing; even direct marketing to the PRC's SWF is prohibited. Consequently, a firm may have to work with PRC firms using programs for qualified foreign or domestic limited partners (QFLPs and QDLPs). The QFII/RQFII fund programs for China-focused investments by foreign institutional investors have also become popular. See "China Launches Landmark Reforms Impacting Hedge Fund Capital Raising, Investments and Operations," The Hedge Fund Law Report, Vol. 5, No. 30 (Aug. 2, 2012). The Hong Kong–China mutual recognition agreement is another possible route into the PRC. Tan said that reverse solicitation is often used in all three jurisdictions, and may be the only way in the PRC. In the PRC, reverse solicitation is used as a defense or a justification in the event of regulatory action. A firm should keep documentation of its activities to assist in establishing a defense.

Tan said that, in deciding whether to enter the Hong Kong, Singapore or PRC market, a firm should consider whether its goal is short-term or long-term. She noted that regulators have long memories: It may be better to apply for a temporary license for a short-term effort to assure that regulators are happy. She cited the high cost of setting up an office in Hong Kong. Another consideration is where the adviser's investors are based: Singapore is popular for marketing to south Asian nations, especially in light of the new regional passports. Hong Kong's big selling point is that it is the only point of access to the PRC. She added that most HNW individuals in the PRC actually have accounts in Hong Kong, so a presence there can give an adviser exposure to PRC investors without the risk of entering the PRC. Finally, certain types of investment vehicles are easier in one jurisdiction than in the other. For example, real estate and debt may be easier in Singapore.

INSURANCE DEDICATED FUNDS

Tax, Structuring, Compliance and Operating Challenges Raised by Hedge Funds Offered Exclusively to Insurance Companies

By Jennifer Banzaca

Insurance dedicated funds (IDFs) are hedge funds offered exclusively to insurance companies and indirectly capitalized by the insurers' life insurance or annuity policyholders. For hedge fund managers, IDFs offer tax advantages, a niche marketing opportunity and a resilient investor base. In connection with a Hedge Fund Association Symposium on the topic being held today in Fort

Lauderdale, The Hedge Fund Law Report recently interviewed Greenberg Traurig shareholder Scott MacLeod on structuring, operational, tax, compliance, marketing and related considerations in connection with IDFs. Specifically, MacLeod addressed salient tax considerations from the perspectives of investors, insurance companies and managers; hedge fund strategies that lend themselves to IDFs; relevant control and diversification requirements; redemption and liquidity issues; consequences of insurer insolvencies; material terms of governing documents; differences between IDFs and reinsurance vehicles launched by hedge fund managers; IDF platforms; private placement variable annuities; and compliance challenges specific to IDFs. See also "Investments by Family Offices in Hedge Funds through Variable Insurance Policies: Tax-Advantaged Structures, Diversification and Investor Control Rules and Restructuring Strategies (Part One of Two)," The Hedge Fund Law Report, Vol. 4, No. 11 (Apr. 1, 2011).

HFLR: What is an insurance dedicated fund and how do funds flow from policyholders to investment in the fund?

MacLeod: An IDF is structured as a regular private fund – an LLC or partnership that generally invests in securities. What differentiates it as an IDF is that for tax reasons, the only investors permitted to invest directly in the fund are insurance companies and their separate accounts. The insurance companies sell insurance products – annuities or life insurance – to investors to capitalize these separate accounts. In this way, the policyholders get the indirect economic results of the fund. These kinds of insurance policies are considered to be securities because the return is based on how the fund does, and not on the health and financial performance of the insurance company. The economics of the policy are based on the performance of the hedge fund. It's really a flow-through or wrapper.

HFLR: What are the chief tax considerations from the perspectives of insureds/investors, the insurance company and the manager of the IDF?

MacLeod: In the U.S., from the investor standpoint, most hedge funds are treated as partnerships for tax purposes. This means gains flow through to investors as they're realized in the fund, whether or not there is any distribution or redemption by the investors. Depending on the investment strategy, it is the performance and how often the funds trade and realize gains that will dictate how much and what kind of tax will be imposed on investors in the fund. The tax code treats insurance products very differently. An investor in an IDF who owns an interest in an insurance product is not taxed on gains in real time as they are earned.

When an investor is taxed will really depend on the type of insurance product the investor buys. Generally, an annuity will not be taxed until such time as the account terminates. If it's the type of product that qualifies as insurance under state law, there actually won't be any tax on gains on any death benefit that's ultimately paid out. Gains are not subject to the 3.8% Medicare tax. There are strategies using trusts that can be used to facilitate estate planning and there are ancillary benefits of liability protection. Adviser incentive compensation is a fee (ordinary income) and not an incentive allocation (potentially capital gains) because the adviser can't have equity in the IDF (which can only be sold directly to insurance companies). [On performance fees versus performance allocations, see "Hedge Fund Managers Using 'Mini-Master Funds' to Retain Favorable Tax Treatment of Performance-Based Revenue from Offshore Funds," The Hedge Fund Law Report, Vol. 2, No. 22 (Jun. 3, 2009) ("Section 457A disallows deferrals of 'fees.' So, mini-masters seek to convert the same revenue from a fee earned for services to an allocation of the various elements of profit and loss.").]

HFLR: Are IDFs best suited to tax-inefficient strategies, such as those that generate short-term capital gains or other income taxed as ordinary income? If so, what are some examples of tax-inefficient strategies that lend themselves to the IDF structure?

MacLeod: IDFs can accommodate just about any kind of trading or investment strategy, so they're not necessarily limited. I think it is true they have the most benefit for strategies that trade frequently and recognize a lot of gains – many of which are short term. However, the deferral benefit and the tax-free death benefit for insurance policies can still be of value over time for less liquid and more tax-efficient strategies. All things being equal, the tax benefit likely is greatest for the high turnover strategies.

HFLR: Can you describe the control and diversification criteria that IDFs must satisfy in order to retain favorable tax treatment?

MacLeod: The price of getting the desired tax treatment is to satisfy diversification and investor control tests that the IRS has applied and interpreted and, as described above, the fund cannot be available directly to the "public," i.e., non-insurance company investors. In broad strokes, these rules are not that difficult to comply with as a practical matter. The requirements do not set an extremely high hurdle. To satisfy the requirement for diversification, for most purposes you're able to look through to the holdings of the fund. In most cases, if you have more than five different investments in the fund, the IDF should be able to qualify, unless any one makes up a huge part of the fund. Similarly, if the IDF is a fund of funds, as long as you invest in five funds, you would also qualify without having to look through the underlying funds. So, the diversification requirements are not very stringent or difficult to comply with.

What allows you to look through in a way that makes diversification easy is satisfying the investor control doctrine. The concept is the investor really shouldn't be dictating what kinds of investments are made or what specific investments are made by the fund. That's a fairly low hurdle to meet. The IRS has determined that it is not impermissible for an investor to suggest who manages the fund or to get to choose from a menu of underlying funds or fund managers. This is not a problem unless the investor is allowed to have input on specific investments made by the IDF manager. However, this is not how hedge funds typically operate, whether they are an IDF or not.

HFLR: Must an IDF, for tax purposes, be structured as a limited partnership or may it also be structured as a limited liability company or an offshore vehicle?

MacLeod: I think some lawyers will say it should not be a limited partnership and should be an LLC because a limited partnership has to have a general partner. The general partner would be the investment manager and not the insurance company. This is at odds with the notion that the only investors allowed in an IDF are insurance companies. You do see them as limited partnerships but I think LLCs are more prevalent. They can be onshore or offshore vehicles. The deferral works whether the entity is onshore or offshore. The investor control and diversification rules are similar with onshore and offshore vehicles. The onshore or offshore decision often is based on where the investor is. In some cases, there may be differences in insurance regulations or premium taxes between U.S. and non-U.S. carriers. In some cases there could be some question about the financial strength and safety of the carrier. There is a thought that maybe the insurance companies in the U.S. are stronger and there's more reinsurance available onshore than offshore. These are somewhat fine points and as a general matter the IDF being onshore or offshore would both certainly be viable.

HFLR: Can an insured/investor withdraw funds from (i.e., redeem from) an IDF while that insured/investor is alive – with or without surrendering the policy – and what are the tax consequences of such withdrawals?

MacLeod: On the insurance side, there can be some penalties with respect to early withdrawal. From the fund standpoint, the funds usually operate quite similarly whether they're an IDF or not. One of the differences for IDF funds is that it is very common to give the insurance company a special right to redeem to pay death benefits or to pay certain policy expenses so it's very common in an IDF to have an override mechanism to any gate or lockup. Other than that, the liquidity at the fund level works similarly. There is some liquidity at the policy level but with penalties.

HFLR: Can an insured/investor borrow against the cash value of the policy and are proceeds of such loans taxable as ordinary income?

MacLeod: Insureds typically can borrow and such loans are not taxable.

HFLR: How do hedge fund managers structure the liquidity and redemption terms of IDFs in light of the unpredictability of the timing of deaths of insureds/investors?

MacLeod: Even though death benefit payments are required, generally because of the penalties we discussed for early withdrawals, IDFs are often viewed as "sticky" assets compared to non-IDFs. With respect to liquidity, you have to be mindful of liquidity but it's typically dependent upon how diversified the investor base is. It should be fairly actuarially unlikely to have a run on the fund based on death benefit claims. So, you have to bear liquidity in mind but I haven't really seen this concern lead to managers doing things much differently than they would for a non-IDF fund. As a general matter, you're going to manage the funds to allow for reasonably foreseeable redemptions.

HFLR: What happens to an IDF if the insurer from which the investor purchased the policy becomes insolvent?

MacLeod: The return of the value of a policy issued by a separate account does not rely upon the general assets of the insurance company, it is based on the assets in the separate account, so if the insurer is at risk there should be an orderly unwind of the policy and the IDF without any real loss of value.

HFLR: How is the relationship among the insurer, the IDF and the IDF's investment adviser or general partner typically documented and what are two or three of the key terms typically found in such documents?

MacLeod: The fund documents, from the manager standpoint, are very similar to the standard documentation of any non-IDF private fund. The distinguishing factor is that the only direct investors have to be insurance companies. The drawback for the manager is that you can't simply use an existing vehicle, as comingling with non-insurance investors is prohibited. That being said, you can use documents that are pretty close to your existing fund documents. Your IDF should not be an exact clone of an existing fund so you're not deemed to have the two "integrated" and so they're not viewed as also having non-insurance company clients. Then there is an offering memorandum that is just like a standard private placement memo and that is given to the insurance company who then hands it out to the policy owners along with the insurance documentation. The partnership agreement or the LLC operating agreement for the IDF is virtually identical to that of a non-IDF fund. There are a few slightly different terms: there is usually a liquidity carve out for death benefits and requirements to meet the diversification standards. The subscription agreement is a little different because it's not signed by the ultimate end-user investor but the insurance company. In many cases there are special supplemental terms put in or a separate participation agreement between the insurance company and the fund manager. In those provisions, the insurance company typically asks for some extra protections and indemnifications against a mistake by the manager failing the diversification test or failing the investor control test.

HFLR: Can multiple insurers invest in a single IDF?

MacLeod: They can. A single IDF can accommodate more than one insurance company and can accommodate annuities and life insurance in the same entity.

HFLR: Are there any noteworthy examples of insurers that invest in IDFs or hedge fund managers that manage IDFs?

MacLeod: This is an institutional, time-tested standard tax planning approach. This is not a gimmick. Some very big carriers are involved and large, brand name hedge funds do these. I think it is a bit of a hidden gem and it's surprising there are not more of these funds in these times when tax deferral can be hard to find. It's not something that is very difficult for managers to set up or requires them to vary their existing practices significantly.

HFLR: What are the two or three key differences between IDFs and reinsurance vehicles launched by hedge fund managers?

MacLeod: Reinsurance is a much different and much more significant undertaking, in terms of barriers to entry. You have to create a licensed and regulated entity of your own. IDFs are much different and much simpler operations.

A reinsurance vehicle involves actually chartering an insurance company, which is a much more significant undertaking than signing a distribution agreement with an existing outside insurance carrier, like you do with an IDF. It's a lot different than taking your familiar fund product and creating a similar vehicle that you offer through a different distribution channel. [For more on reinsurance vehicles, see "How Can Hedge Fund Managers Use Reinsurance Businesses to Raise and Retain Assets and Achieve Uncorrelated Returns? (Part Two of Two)," The Hedge Fund Law Report, Vol. 6, No. 3 (Jan. 17, 2013).]

HFLR: What is an IDF platform?

MacLeod: Platforms have become very popular for private funds and separate accounts and, more recently, with alternative mutual funds. [See, e.g., "Considerations for Hedge Fund Managers Looking to Join Managed Account Platforms (Part Two of Two)," The Hedge Fund Law Report, Vol.

5, No. 31 (Aug. 9, 2012).] Platforms are a turnkey solution that a new manager can plug into to save a lot of the overhead, hassle and headache of launching its own IDF – even though it's not a prohibitively expensive or difficult task to launch your own IDF. A platform would be a multi-series LLC that itself is an IDF, and has a suite of existing relationships with insurance companies. [On multi-series structures, see "Understanding the Benefits and Uses of Series LLCs for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012); and "Cayman Islands Segregated Portfolio Companies: New Case Law Highlights Attractions for Promoters and Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 29 (Jul. 26, 2012).]

A particular manager can come in, plug in and take over one or more series of the LLC and offer those on a "private label" basis as its own without the need to negotiate separately with insurance companies or set up its own legal entity. They will have some requirements of fund formation documents. In some instances, managers can lever off existing forms of offering memos that have been provided by the platforms. They're a highly efficient and quick way of entering the market.

HFLR: What is a private placement variable annuity and how is such an annuity similar to and different from an IDF?

MacLeod: There are carriers and others who are trying to develop and wrap slight variations on the IDF products to deliver deferrals (including deferral of manager incentive fees) and, in some cases, seek to allow a manager to manage its own money or allow some mingling of non-insurance investors for economies of scale.

HFLR: Beyond the control and diversification requirements, are there compliance challenges unique to IDFs?

MacLeod: One challenge we've addressed with some managers is that you don't want the fund to be an exact clone of other funds you manage to avoid any charge that the fund is publicly available to people other than insurance companies. That can raise some issues on performance marketing because managers like to use their non-IDF performance in performance presentations and the performance comparisons need to be apples to apples. If you're changing the IDF a bit so it's not viewed as an exact clone, then there are questions of whether or not the products are similar enough to be compared using the same track record. That said, they are typically very close and, accordingly, are often compared with some disclaimers and disclosures about the differences.

LITIGATION

Bridgewater Associates Sues Ex-Employees Who Allegedly Seek to Trade Off Its Name and Goodwill

By Vincent Pitaro

Hedge fund giant Bridgewater Associates, LP (Bridgewater), recently filed a civil complaint against two former junior employees who allegedly misrepresented their former roles at the fund manager in an effort to promote a competing hedge fund business. Bridgewater bills itself as "both a market- and thought-leader in the field of investment management." The crux of its complaint is that, in their efforts to start and promote their own hedge funds, former employees Wenquan Wu and Howard Wang and their affiliated companies lied to the market about their former roles and responsibilities at Bridgewater and sought to trade unfairly off of Bridgewater's reputation. This article summarizes Bridgewater's factual allegations and legal claims.

Litigation often arises when principals or senior employees leave to form a competing fund. See "Brevan Howard Co-Founder Sues Firm to Invalidate Non-Compete Provisions in Partnership Agreement," The Hedge Fund Law Report, Vol. 7, No. 31 (Aug. 21, 2014); and "Delaware Chancery Court, Criticizing Both Sides in Contentious Litigation, Awards $4.662 Million to Camulos Capital Hedge Fund Founder in Payment for His Fund Interest," The Hedge Fund Law Report, Vol. 5, No. 38 (Oct. 4, 2012). Such disputes may also involve ownership of intellectual property, misuse of proprietary or confidential information, sloppy documentation of payments and sloppy drafting of governing documents. Such actions are less common when, as here, junior employees are involved.

Factual Background

Plaintiff Bridgewater Associates, LP (Bridgewater) is a fund management company founded by Ray Dalio in 1975. It offers hedge fund products to institutional investors. Bridgewater says that it has over $150 billion in assets under management, of which over $70 billion are held in its flagship "All Weather" global macro fund, which follows a proprietary "risk parity" strategy. The defendants are former Bridgewater employees Wenquan "Robert" Wu and Howard Wang and a number of entities they formed under the "Convoy Funds" moniker: Convoy Fund, LP; Convoy Funds, LP; Convoy Global Fund, LP; Convoy Investments, LLC; Convoy Macro Fund, LP; Convoy Optimal Fund, LP; and Convoy Premium Fund, LP; each of which is organized in Delaware and has its principal place of business in New York City (collectively, Convoy). Bridgewater filed its complaint in the U.S. District Court for the Southern District of New York.

According to the complaint, Wu began working for Bridgewater in February 2007. Initially, his "primary responsibilities involved coding isolated portions of software applications used to calculate certain Bridgewater fees." In April 2008, he was moved to Bridgewater's "Core Technology" department, where he was engaged in "discrete coding projects" for Bridgewater's information technology systems. Wang joined Bridgewater in September 2008 as an "entry-level, junior analyst" in its Client Services department. Wang "spent his time supporting others on marketing projects and responding to routine client requests." Bridgewater stresses that neither Wu nor Wang was ever involved with its account management, research or trading departments – those departments alone "devise and implement Bridgewater's trading and risk management strategies." Bridgewater characterizes their roles and duties as follows:

Neither Mr. Wu nor Mr. Wang had any responsibility for, or experience with, managing, overseeing, or operating Bridgewater's funds, portfolios, or investment strategies. Whereas Mr. Wu was granted limited access to confidential information relating to the specific fee-calculation software and other applications with which he worked during his time at Bridgewater, his responsibilities as a software developer never entailed the actual management or operation of any Bridgewater fund. And although Mr. Wang was likewise exposed to certain proprietary Bridgewater information as a junior analyst in Client Services, he was never asked or permitted to in any way manage or oversee any Bridgewater fund. Nor did he ever make any investment decisions for Bridgewater.

Wu left Bridgewater in April 2010; Wang left in January 2012. Each was subject to a confidentiality and non-competition agreement that (1) prevented him from directly or indirectly engaging in any business in competition with Bridgewater for a period of two years and (2) required him to notify Bridgewater of potential employment opportunities before accepting or engaging in them. See "Schulte Roth & Zabel Partners Discuss Non-Competition and Non-Solicitation Provisions and Other Restrictive Covenants in Hedge Fund Manager Employment Agreements," The Hedge Fund Law Report, Vol. 4, No. 42 (Nov. 23, 2011). Wu allegedly told Bridgewater that he would be "traveling" during the non-compete period; Wang said he was going to pursue competitive ballroom dancing. Bridgewater stresses that their duty not to use its confidential information is unlimited in duration. See "Recent Developments Affecting the Protection of Trade Secrets by Hedge Fund Managers," The Hedge Fund Law Report, Vol. 6, No. 41 (Oct. 25, 2013).

Bridgewater states that, in January 2013, it modified Wang's non-compete to permit him to "look after the savings" of certain friends and family members as a "side business." Wang allegedly agreed that, for the remaining year of his non-compete term, he would not "provide any asset management services or investment advice, either directly or indirectly, to anyone other than family members or personal friends" or "use, develop, or market any investment or trading strategy (or any substantially similar investment strategy or strategies) that was used, developed, or investigated by Bridgewater during his employment, including, but not limited to, the global macro fundamental approach or the All Weather approach." Bridgewater alleges that, despite this agreement, Wu and Wang took "steps to launch their own competing hedge fund" in July 2012, when they formed one of the Convoy entities and registered a domain name for Convoy. In March 2014, after termination of his non-compete period, Wang allegedly told Bridgewater that he planned to launch a hedge fund that would pursue a strategy similar to Bridgewater's "All-Weather growth/inflation framework" and that the new fund would be marketed to institutional investors.

Alleged False Claims

According to the complaint, Wu and Wang embellished their firm biographies and misrepresented their duties and responsibilities at Bridgewater to "trump up [their] investment credentials" and attract investors. Those biographies read:

> Howard [Wang] is a co-founder of Convoy Investments and is responsible for research and portfolio management. Prior to founding Convoy in 2013, ***Howard spent his career managing portfolios for institutional investors, most recently at Bridgewater Associates*** where he and Robert *[Wu]* first met. ***Howard was part of a 3-member investment team responsible for overseeing and marketing the $70 billion All Weather Strategy*** on behalf of some of the largest and most sophisticated investors in the world, including sovereign wealth funds, pensions, endowments and foundations.
>
> As the co-founder of Convoy Investments, Robert [Wu] is responsible for strategic business planning and trading operations. Prior to founding Convoy, ***Robert spent his career working in technology and operations, most recently at Bridgewater Associates, where he was part of the team that built and oversaw critical components of operations systems.***

(Emphasis supplied by Bridgewater.) Bridgewater also cites articles and other publications in which Wang allegedly claimed that he was an analyst on "the investment team" for Bridgewater's All Weather fund and that he helped to "market and oversee" that fund.

Bridgewater charges that all of those statements are "both literally false and materially misleading." Wang was, in fact, only a "junior analyst," one of about 200 analysts at Bridgewater. He never managed or had any investment authority over Bridgewater portfolios or assets. Similarly, Wu was merely "a junior-level software developer and technician, who worked on only one sliver of Bridgewater software related to the calculation of client fees." He had nothing to do with its trading or overall operations. According to Bridgewater: "Embedded within each of [Wu's and Wang's] statements is the false and damaging suggestion that Mr. Wu and Mr. Wang are former high-profile Bridgewater employees, who were each responsible, in a primary role, for the development, management, or implementation of Bridgewater's world-renowned investment strategies." This allegedly created confusion in the marketplace.

Finally, Bridgewater alleges that its extensive management experience has allowed it to "identify and master a set of fundamental 'timeless and universal' economic truths that hold true 'across time' and 'across countries.'" Bridgewater appears to be laying claim to those concepts: It charges that Convoy's website described its investment philosophy using terminology that improperly "mimics" Bridgewater's expressions:

> To create a portfolio that truly protects an investor's financial future requires a deep, ***timeless, and universal understanding of how markets work*** and how asset prices move. . . . [A]t their most fundamental level, the economy and the markets can be understood through basic yet ***timeless and universal logic.*** . . . A portfolio designed to perform consistently over long periods of time must be based ***on an* ageless *logic*** . . . .

(Emphasis supplied by Bridgewater.) When Bridgewater confronted Wu and Wang about their marketing efforts, they allegedly pledged to stop using the alleged false claims. Instead, Bridgewater claims that they password-protected Convoy's website (allegedly to make the offending claims harder to find) and continued to suggest, both on that website and in a federal trademark application, that they had managed portfolios for institutional investors at Bridgewater.

Lanham Act Claim

Although much of the complaint is couched in the language of unauthorized competition, and Bridgewater expresses its concerns that the defendants may be using its proprietary information, Bridgewater is actually asserting a single claim under federal trademark law, commonly known as the Lanham Act (15 U.S.C. §1051 et seq.). Bridgewater claims that the defendants violated Section 1125(a)(1)(B) of that Act, which establishes a private right of action for certain false or misleading advertising:

> (1) Any person who, on or in connection with any goods or services, or any container for goods, uses in commerce any word, term, name, symbol, or device, or any combination thereof, or any false designation of origin, false or misleading description of fact, or false or misleading representation of fact, which . . . (B) in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services, or commercial activities, shall be liable in a civil action by any person who believes that he or she is or is likely to be damaged by such act.

Bridgewater charges that the defendants' statements are "literally false, and expressly and/or impliedly misrepresent the nature, characteristics, and qualities of Convoy's products and services in a material way," such that consumers may be confused and choose Convoy over Bridgewater. It claims that the defendants made those statements "knowingly and intentionally." By positioning Convoy as a "direct competitor of Bridgewater," the defendants have "irreparably and unfairly" damaged Bridgewater, including its reputation and goodwill.

Bridgewater seeks an injunction (1) requiring the defendants to remove any false claims from the public domain and (2) prohibiting the defendants from claiming that any of the alleged false statements are true or that they or any of their products, services or activities "are associated or connected in any way with Bridgewater." It also seeks triple compensatory damages and attorneys' fees.

To view the complaint, click here.

PEOPLE MOVES

Kleinberg Kaplan Continues Expansion of Hedge Fund Practice with Addition of Attorney Jared Gianatasio

By David Chana

On October 30, 2014, Kleinberg, Kaplan, Wolff & Cohen, P.C. announced that Jared R. Gianatasio has joined the firm as senior counsel where he will focus his practice on investment funds and derivatives. For insight from the firm, see "The Impact of Revenue Ruling 2014-18 on Compensation of Hedge Fund Managers and Employees," The Hedge Fund Law Report, Vol. 7, No. 24 (Jun. 19, 2014); "A Checklist for Updating Hedge Fund and Service Provider Documents for FATCA Compliance," The Hedge Fund Law Report, Vol. 7, No. 7 (Feb. 21, 2014); and "Insurance Dedicated Funds Offer Hedge Fund Exposure Plus Tax, Underwriting and Asset Protection Advantages for Investors," The Hedge Fund Law Report, Vol. 6, No. 28 (Jul. 18, 2013). Gianatasio was previously a senior associate in the New York office of Shearman & Sterling LLP, where he practiced in the firm's derivatives and investment funds practice. He follows the arrival, in August, of Joseph Iskowitz to the firm's hedge fund practice.

Gianatasio has extensive experience representing market participants in the structuring and documentation of complex over-the-counter and exchange-traded derivatives transactions. See "Five Steps for Proactively Managing OTC Derivatives Documentation Risk," The Hedge Fund Law Report, Vol. 7, No. 16 (Apr. 25, 2014). This includes developing, drafting and negotiating highly structured derivative and repurchase agreements, master trading agreements/confirmations and other account documentation for derivatives and other financial products. He also represents hedge funds in fund formation matters. See "Tax Practitioners Discuss Taxation of Foreign Investments and Distressed Debt Investments at FRA/HFBOA Seminar (Part Three of Four)," The Hedge Fund Law Report, Vol. 7, No. 4 (Jan. 30, 2014). On the regulatory side, Gianatasio advises market participants and industry groups on derivatives and securities regulatory and risk management issues, including regulatory and compliance requirements under the Dodd-Frank Act and Volcker Rule. He also represents investment fund managers on a variety of ongoing CFTC and SEC regulatory and compliance matters.

"Jared's strong experience in derivatives trading, fund formation and regulatory matters increases the versatility of our team and provides added value to our clients," said Eric Wagner, chair of the firm's corporate department. "Regulations governing funds and derivatives continue to evolve, requiring complex knowledge of the law, the market and its players. Jared is a great fit for our firm and will further enhance our practice."

PEOPLE MOVES

Investment Funds Counsel Joins Latham & Watkins in Chicago

By David Chana

On October 23, 2014, Latham & Watkins LLP announced that Nancy Kowalczyk has joined the firm's Chicago office as counsel in the Investment Funds Practice Group within the firm's Corporate Department. She joins from Kirkland & Ellis LLP in Chicago.

Kowalczyk focuses her practice on the representation of investment advisers, private investment funds and broker-dealers, and she has significant experience representing hedge funds and their sponsors. She also advises clients regarding regulatory and compliance issues; mergers, acquisitions and joint ventures involving investment advisers, broker-dealers and funds; private offerings of securities; and fund formations. On investment adviser M&A, see "How Will the SEC's New Pay to Play Rule Impact Mergers and Acquisitions of Hedge Fund Management Companies?," The Hedge Fund Law Report, Vol. 3, No. 31 (Aug. 6, 2010).