The
HEDGE FUND
LAW REPORT
The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 9, Number 41 October 20, 2016

REGULATION

Seward & Kissel Private Funds Forum Offers Practical Steps for Fund Managers to Address HSR Act Enforcement, Tax Reforms, Brexit Uncertainty, MiFID II, Cybersecurity and Side Letters

By Michael Washburn

Years after the financial crisis, private funds in the U.S. and Europe continue to be affected by factors as varied as the trends in enforcement of the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act); reforms to the U.S. tax code; ongoing uncertainty over Brexit, including whether the U.K. will make a "hard" or "soft" departure from the E.U.; cybersecurity risks; and selective disclosure concerns.

These issues were the focus of the second segment of the second annual Private Funds Forum co-produced by Bloomberg BNA and Seward & Kissel (S&K) on September 15, 2016. Entitled "Adapting to a Changing Regulatory and Business Environment," the panel was moderated by S&K partner Robert Van Grover and featured James E. Cofer and David R. Mulle, also partners at S&K; Richard Perry, a partner at Simmons & Simmons; Matthew B. Siano, managing director and general counsel of Two Sigma Investments; and Mark Strefling, general counsel and chief operating officer of Whitebox Advisors. This article highlights the salient points made by the panel.

For coverage of the first segment of this forum, see our two-part series: "*How Managers Can Mitigate Improper Dissemination of Sensitive Information*" (Sep. 22, 2016); and "*How Managers Can Prevent Conflicts of Interest and Foster an Environment of Compliance to Reduce Whistleblowing and Avoid Insider Trading*" (Sep. 29, 2016).

HSR Act Enforcement

Regulatory overreach is a defining characteristic of the changing environment, said Mulle, which is evident in enforcement of the HSR Act. The HSR Act requires an investor to make a filing with the government before the investor crosses a certain threshold – at present, $78.2 million – of investment in a given company. Following a filing, the government has a chance to conduct analysis to determine whether it is permissible for the investor to exceed that threshold.

For more on activist investing, see "*Structures and Characteristics of Activist Alternative Investment Funds*" (Mar. 12, 2015); and our two-part series on "*Considerations for Hedge Fund Managers Pursuing Activist Strategies*": "*Filing Obligations and Other Operational Considerations*" (May 5, 2016); and "*Settlement, Prospects, Shareholder Engagement and Proxy Access Considerations*" (May 12, 2016).

Under the HSR Act, an investor has the benefit of a number of possible exemptions. One exemption, on which Mulle said the investment adviser industry has come to depend, is a "passive investor" or "investment only" exemption. This exemption allows an investor to avoid making HSR Act filings if it owns less than 10 percent of a particular issuer and if it does not intend to participate in the business decisions of the issuer (e.g., become an activist).

ValueAct Capital relied on this exemption in declining to make an HSR filing with the government when its investments in Halliburton Company and Baker Hughes Incorporated, respectively, exceeded the then-applicable thresholds. In its enforcement action against ValueAct, the DOJ alleged that the exemption did not apply because ValueAct took its positions in those two firms with a view to making it easier for their proposed merger to occur. Hence, in the DOJ's view, ValueAct could not be considered

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a passive investor. See "*DOJ Lawsuit May Limit Ability of Activist Hedge Funds to Rely on 'Investment Only' Exemption From Hart-Scott-Rodino Filing Requirements*" (Apr. 14, 2016).

According to Mulle, ValueAct's activities actually did not go beyond holding discussions with the firms' executives and putting forth suggestions about how to pave the way for the merger. ValueAct opted to settle with the government, he explained, in part because the government had sharply increased the daily fine for failure to make the HSR Act filing from $16,000 to $40,000. "ValueAct basically said, 'Look, there's enough uncertainty here that it makes sense to settle for a lesser amount with the government,'" he added. See "*Settlement Clarifies Limitations on Activist Hedge Fund Access to the 'Investment Only' Exemption from Hart-Scott-Rodino Filing Requirements*" (Jul. 21, 2016).

Investors taking positions with a particular issuer who are approaching the current HSR Act filing threshold should proceed with caution, advised Mulle. "The fact that the government took this position with respect to ValueAct makes it incumbent on you to make sure that you are very comfortable that you actually are able to rely on this passive investor exemption, because the consequences of being wrong have gone drastically up," he said, emphasizing that it is imperative for investors or potential investors to think carefully about their communications with an issuer, as well as conversations that take place internally or with other investors.

Tax Regulations

Revised Partnership Audit Rules

Cofer analyzed recent changes to U.S. tax law that will have significant ramifications for the auditing of partnerships. Under current rules, he said, adjustments imposed on partnerships resulting from audits apply to partners in the year the audit covers. For example, if 2016 is the year covered by the audit, then any adjustments will affect people who are investors in the fund in 2016. However, under the revised regulations, which go into effect in 2018, the default rule will be that any tax deficiency will fall upon those who are partners in the year in which the audit concludes. Cofer emphasized that this change is particularly significant for hedge funds, given that the partners in a hedge fund in the year when the audit wraps up is likely to be different – perhaps drastically so – from those in the year that the audit covers.

Under the new rules, an election is available that will allow partners to push the tax out to those who are actually investors in the year under audit, noted Cofer. That might sound like good news, but the push-out election may not be available in a tiered partnership structure (e.g., a master-feeder structure), he explained. "If master funds are audited, it would just mean that it got pushed out to the master fund," he added, "but the domestic fund couldn't push back."

On a positive note, Cofer held out hope that the regulations around this issue may be clarified in a way favorable to tiered partnership structures. He foresaw, however, a chilling effect if no such clarification were to occur. "It's really going to give folks pause as to whether they really want to continue with master-feeder structures," he postulated, "or maybe we'll see folks go back to more side-by-side structures to avoid that issue."

For more on the new partnership audit rules, see our two-part series "*A Bipartisan Problem for Private Funds*": "*How Current Regulations Complicate IRS Audits of Partnerships*" (Apr. 21, 2016); and "*How Revised Regulations Facilitate IRS Audits of Partnerships*" (Apr. 28, 2016).

Tax Liabilities Driving Investor Demand

People may begin to view hedge funds more like mutual funds or corporations – where they may be buying into a tax liability when making investments – which would make it imperative for them to scrutinize financial statements, anticipated Cofer. He analyzed a general tendency since 2008

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for funds to defer fees and charge an allocation for the purpose of avoiding New York City's unincorporated business tax (UBT). See "*Proposed New York City Audit Position Can Increase the Amount of Unincorporated Business Tax Paid by New York Hedge Fund Managers*" (Jan. 12, 2012).

However, recent tax changes – including the introduction of the Affordable Care Act (ACA) tax – have challenged how funds operate and the assumptions investors make when entering funds. When a fee is paid, and the investment manager organizes a limited partnership, he noted, it is possible to take a position under the current laws that the fee avoids the self-employment tax. In essence, the payer is trading the 3.8 percent ACA tax for a 4 percent UBT that is deductible for federal tax purposes.

"The thing to think about, for those funds, is that you may want to charge a fee, certainly on the offshore side," Cofer said. "On the domestic side, what's the disadvantage to investors? It's a matter of constantly questioning the old assumptions."

Ramifications of Brexit

Perry described a state of turmoil in Europe following the June 23, 2016, vote in favor of Britain's departure from the E.U. In spite of what the "existential crisis" following the vote, he noted that a country planning to exit must give two years' notice before it actually leaves under Article 50 of the E.U.'s charter. The British government has been giving subtle hints that it will not deliver that notice until perhaps the end of 2017, so there is a bit of time to work with.

"Things are quiet at the moment, with managers undertaking an assessment of what the impact will be of a 'hard' Brexit – the terminology being used for a Brexit where there's no continuing access to the financial services single market in Europe," Perry stated. See "*What Today's Brexit Vote Could Mean for Hedge Fund Managers*" (Jun. 23, 2016); as well as our two-part series: "*Effect of Hard vs. Soft Brexit on Hedge Fund Managers*" (Jul. 7, 2016); and "*Hedge Fund Marketing and Distribution Opportunities in a Post-Brexit World*" (Jul. 14, 2016).

One issue that Perry said requires review and analysis is the fact that many U.S. fund managers operate with a U.K. subsidiary entity. Those managers will have to understand issues of passporting rights under the Alternative Investment Fund Managers Directive if they wish to continue marketing and distributing products in Europe through their U.K. subsidiaries. See "*Marketing Strategies for U.S. Hedge Fund Managers Under AIFMD (Part One of Two)*" (Jul. 21, 2016).

U.S. fund managers operating in the E.U. must also monitor recent market abuse regulations covering a wide range of insider trading and market manipulation offenses. For example, Perry explained, "there is a new specific offense of canceling or amending orders that haven't been committed yet, and that likely contradicts the advice you may have been given in the U.S." He proceeded to emphasize the extra-territorial nature of the regulations, urging U.S. fund managers not to overlook the fact that regulations in Europe apply to them – even if they are not based there – as long as they conduct transactions there. See "*E.U. Market Abuse Scenarios Hedge Fund Managers Must Consider*" (Dec. 17, 2015); and "*Ten Practical Consequences for Hedge Fund Managers of the FCA's Thematic Review of Asset Managers and the E.U. Market Abuse Regulation*" (Mar. 19, 2015).

MiFID II

Perry went on to address the ramifications of the revised E.U. Markets in Financial Instruments Directive (commonly referred to as "MiFID II") for third-country fund managers. He described MiFID II as a huge regulatory change, focusing to a great extent on transparency issues and market operations. The changes have gone ahead under the leadership of a U.K. regulator, and the U.K. will be implementing MiFID II reforms regardless of whether the country remains part of the E.U.

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There is more than enough material available to the public to begin working on MiFID II compliance issues, stressed Perry, who was optimistic as he described the third-country regime available under MiFID II. Under this provision, if the European Commission considers the U.S. to have an equivalent regulatory regime to the one in place in Europe, U.S.-based managers will be able to offer investment management services in conjunction with professional investors in E.U. member states.

For more on MiFID II, see "*ESMA Chair Outlines Rulemaking Authority and Implementation of MiFID II*" (Jul. 14, 2016); "*MiFID II Will Affect Market Structure, Registration and Soft Dollars for Hedge Funds Trading in Europe*" (May 19, 2016); and "*FCA Urges Hedge Fund Managers to Prepare for MiFID II*" (Oct. 29, 2015).

Harmonization of Compliance Programs

Siano offered practical steps for fund managers faced with a seeming gulf between the disparate regulatory regimes of the U.S. and foreign jurisdictions. "If you're building on the base of the U.S. program, there is the whole question of process building – and the role of technology in being able to do that – across time zones and business hours," he added. Fund managers need to try to find someone who is knowledgeable about the different regimes and who can be deputized to customize the idiosyncratic aspects of the familiar domestic program to make them compatible with those of the U.K., Hong Kong and other places.

These "champions" need to specifically understand regulatory issues that apply to control functions, compliance, investor relations and portfolio management in each jurisdiction, concurred Strefling. Additionally, they need to understand their organizations' activities in various jurisdictions and states; grasp what regulatory responses those activities might trigger; and understand where there will be symmetry, conflict or additional regulatory requirements.

Cybersecurity

Expanding on the above compliance issues, Siano emphasized steps fund managers can take to protect both fund information and their own portfolio management tools. Urging managers to make sure they have the basics of general security in place, he reminded them that threats come from inside as well as outside of organizations. Various safeguards that fund managers should implement include software patches, monitoring processes, password databases and safeguards against phishing, as well as securing the equipment that houses sensitive data.

Additionally, managers should prune back employee access to sensitive information as much as possible so that people get data on a need-to-know basis, Siano suggested, as opposed to a general, free-for-all basis. "Then step back and think about some of the weird ways that people can access your system," he continued. "For example, do you provide free Wi-Fi in your office, and does that inadvertently give your guests access?" he added, urging managers to recognize that mistakes often occur through sloppiness.

For more on cybersecurity issues, see "*FCA Director Lays Out Expectations for Cybersecurity of Financial Services Firms: Identification of Cyber Risks, Detection, Firm Preparedness and Information Sharing*" (Sep. 29, 2016).

Side Letters and MFN Status

Mulle made reference to an S&K study devoted to side letter terms, and its finding that improved liquidity is a relatively rare feature of side letters. See "*Seward & Kissel Study Finds MFN Clauses and Reduced Fees Most Prevalent Terms in Side Letters*" (Oct. 6, 2016).

The most common provisions in side letters are most favored nation clauses, followed by fee discounts. The latter tend to occur in the cases of fund managers with assets under management (AUM) of under $1 billion, Mulle noted, though there are some with more than $1 billion in AUM who also have fee discounts.

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The third most common side letter provision cited in the report was increased transparency. See "*SEC Commissioner Calls for Increased Transparency and Accountability in Capital Markets*" (Mar. 3, 2016). Mulle said that this is an issue fund managers need to think about carefully, including how disclosures match up with fund liquidity. Moreover, fund managers need to be aware that having these provisions may mean that they have an obligation to go out to all investors with written information that may be material at a time the fund managers may not find ideal.

Strefling added, "I think side letters are a kind of extension of what we were talking about with due diligence." He emphasized the importance for fund managers understanding what provisions mean with respect to transparency risks and regulatory risks. "Thinking through where you want to be with respect to side letters, and ensuring that you have consistency among your side letters, is very helpful in terms of managing a process," he explained.

For more on side letters, see "*How Hedge Fund Managers Can Accommodate Heightened Investor Demands for Bespoke Negative Consent, Liquidity, MFN and Other Provisions in Side Letters*" (Oct. 13, 2016).

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