The Hedge Fund Law Report
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Asia

Structuring, Regulatory and Tax Guidance for Asia-Based Hedge Fund Managers Seeking to Raise Capital from U.S. Investors (Part One of Two)

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U.S. hedge fund investors are continuously seeking attractive investment opportunities and are increasingly expanding their search to incorporate Asia-based hedge fund managers. At the same time, Asia-based hedge fund managers are navigating the challenging capital raising environment by reaching beyond their borders to attract U.S. investors. However, Asia-based fund managers seeking to attract capital from U.S. investors must contend with a plethora of U.S. and foreign regulations in raising and managing such capital. As such, Asia-based fund managers must work closely with U.S., Cayman and local counsel to develop a cohesive and carefully thought out fund and management structure, intertwining the various regulatory requirements of the applicable jurisdictions, all of which must be adhered to by the fund manager, any sub-advisers and their respective affiliates.

This is the first in a two-part series of articles designed to help Asia-based fund managers navigate the challenges of structuring and operating funds to appeal to U.S. fund investors. This first article describes the preferred Cayman hedge fund structures utilized by Asia-based fund managers, the management entity structures, Cayman Islands regulations of hedge funds and their managers and regulatory considerations for Singapore-based hedge fund managers. The second article in the series will detail a number of the key U.S. tax, regulatory and other considerations that Asia-based fund managers should consider when soliciting U.S. taxable and U.S. tax-exempt investors.

Fund Structuring Considerations

The Cayman Islands are widely used and considered the jurisdiction of choice for Asia-based fund managers to structure funds to appeal to U.S. investors. The key reasons for utilizing the Cayman Islands as the jurisdiction of choice include: (1) the Cayman Islands' robust legal system (based on the English common law system); (2) recognition of the Cayman Islands as the jurisdiction of choice among institutional investors; (3) greater privacy protections; (4) a favorable regulatory environment as compared with other offshore jurisdictions; and (5) a zero taxation regime.

Cayman Islands law offers three categories of entities as suitable candidates for investment vehicles – the company, the partnership and the unit trust. Overwhelmingly, the vehicle of choice for Asia-based hedge fund managers is the Cayman Islands exempted company. A Cayman Islands exempted company is a limited liability company which is able to obtain a written guarantee of tax-exemption from the Cayman Islands government for a period of twenty years.

For Japan-based fund managers, however, the Cayman Islands exempted unit trust is the vehicle of choice for structuring hedge funds. The Cayman Islands exempted unit trust was created to mirror the structure commonly utilized for funds domiciled in Japan, which are also generally structured as unit trusts, a form of fund entity very familiar to Japanese investors. The use of the unit trust vehicle by

Japan-based fund managers also provides beneficial taxation and accounting treatment in Japan. Similar to a director in a traditional corporate structure, the trustee of a unit trust, typically organized as a Cayman Islands licensed trust company,[1] is responsible for the overall business and affairs of the unit trust. A trusteeship is a fiduciary relationship, and the trustee is bound to act in a *bona fide* manner in respect of its dealings with the trust, exercising reasonable care and skill in its judgment. The trustee has a duty to act in the best interests of the unitholders. Similar to directors in a corporation, the trustee will generally have a right of indemnity from the unit trust in respect of most liabilities incurred and will seek to expressly limit its liability to the level of assets in the unit trust (which will of course fluctuate over time). An investor's share in the assets of a unit trust is represented by "units" which are usually transferable, subject to any restrictions on transfer contained in the trust deed, the primary constitutional document of a unit trust. The trust deed will usually give investors the right to redeem their units and to purchase additional units. The circumstances in which an investor may purchase and redeem units normally mirror those of a fund organized as a corporation.

The obligations of a trustee will vary with the particular provisions of the trust deed. The trust deed for a unit trust customarily grants to the trustee wide powers of investment in order to achieve the fund's investment objectives. In turn, the trustee usually delegates the authority to invest the trust assets to a professional investment manager/adviser or the fund promoter and accordingly the role of the trustee is not too dissimilar to that of a corporate fund's board of directors, which typically delegates the authority to invest the fund's assets to an investment manager.

Although partnerships are more commonly utilized by Asia-based fund managers for organizing private equity funds, they are also sometimes utilized to organize hedge funds. The most common use for partnerships in hedge fund structures with Asia-based managers is to organize a master fund in a master-feeder structure (discussed below). Partnerships are useful as their terms can be drafted very broadly and they are less restricted than companies in respect of the ability for committed capital to be called and paid over time and the ability to return capital to investors. Similar to the unit trust structure, where a partnership vehicle is utilized, the traditional role of the directors in a corporate structure will be undertaken by the general partner of the partnership. The general partner is generally organized as a Cayman Islands exempted company, although, in certain circumstances, it may be an individual, a partnership or a corporation from a jurisdiction other than the Cayman Islands. If the general partner is a foreign entity, such entity will be required to register as a foreign company in the Cayman Islands. As the general partner has potential unlimited liability in relation to the liabilities of the partnership, it is extremely rare in practice for an individual to act as the general partner of a fund organized as a partnership.

Within the above framework, fund managers may adopt a number of common structures for Cayman Islands domiciled hedge funds. The most common are the stand-alone structure, the master-feeder structure, parallel structures and umbrella funds. Each of these fund structures is discussed in detail below.

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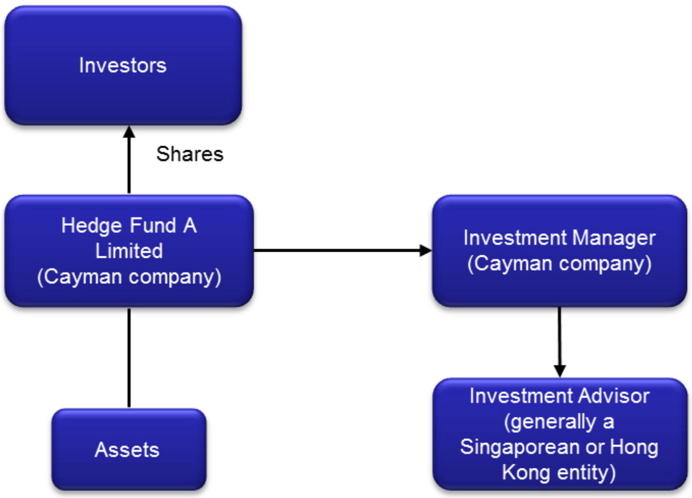
www.hflawreport.com Volume 5, Number 31 August 9, 2012

Stand-Alone Funds

As the name suggests, a stand-alone fund is a single investment vehicle which, on its own, pursues a particular investment strategy. A stand-alone entity will issue interests to investors and will hold the pooled assets for the benefit of investors.

Set out below is a diagram of a typical stand-alone hedge fund structure established as a Cayman Islands exempted company. As noted above, the fund vehicle may also be established as a unit trust or a partnership.



Master-Feeder Structures

A master-feeder structure is a tiered structure (with two or more tiers) where the combined assets from separate feeder funds are invested into a separate downstream vehicle, which is known as the "master fund," usually managed by the same investment manager. The master fund will act as the investment vehicle for the feeder funds.

There are a number of key reasons for establishing a master-feeder structure as opposed to a stand-alone fund. The primary reason is to accommodate investors from different jurisdictions who have different tax, reporting or accounting requirements. For instance, U.S. taxable investors typically invest into a feeder fund separate and apart from non-U.S. or U.S. tax-exempt investors, as the two groups of investors have very different taxation and reporting obligations and would trigger differing reporting obligations for the feeder fund. Feeder funds also may be used to provide different investors with their own preferred choice of entity. For instance, a manager may set up a feeder fund which is structured as a unit trust to attract Japanese investors and a separate corporate feeder fund to attract investors from Hong Kong, as these respective vehicle types will be more familiar to investors from these different jurisdictions.

The master-feeder fund structure also allows investment managers to address currency hedging concerns. If the master fund's functional currency is in U.S. dollars, but the manager aims to attract investors who wish to subscribe in currencies other than the U.S. dollar, such as Japanese yen, it may choose to establish a separate Japanese yen-denominated feeder. The creation of a separate currency denominated feeder fund will ensure that only the investors in the Japanese yen-denominated feeder fund bear the costs of the necessary currency hedging. This may also be achieved through issuing share classes with different currency denominations within the same feeder fund.
Set out below is a diagram of a typical corporate master-feeder hedge fund structure.

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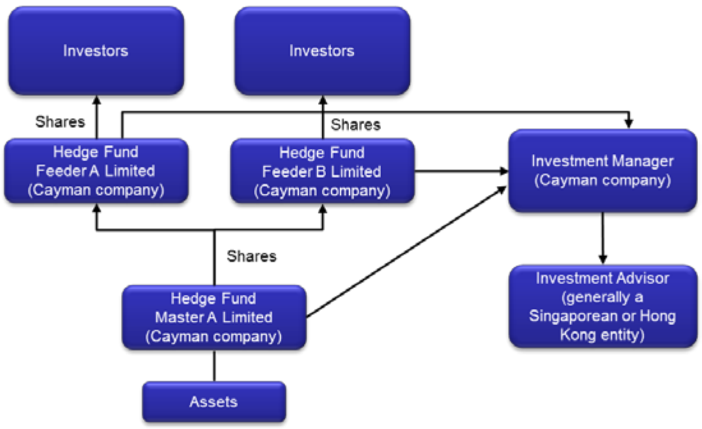
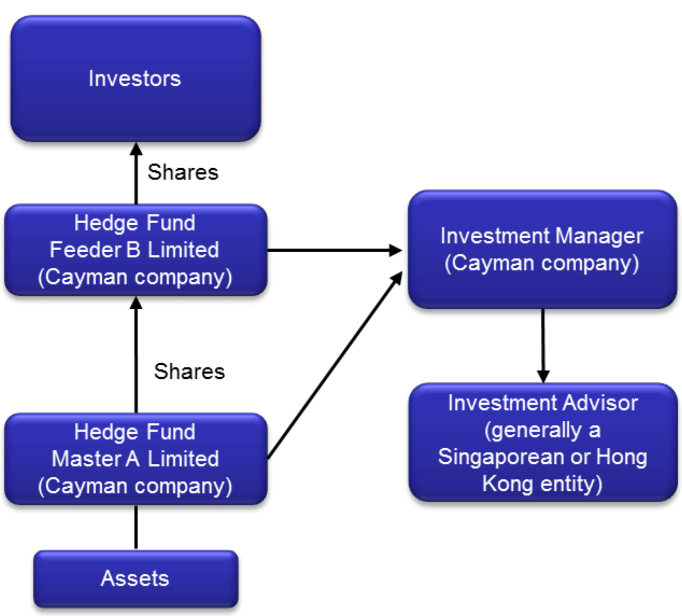


It is also common for Asia-based fund managers to establish a "single-legged," "one-legged" or "partial" master feeder structure from inception. The advantage of this approach is that the infrastructure for expansion is put in place from the outset and allows managers to easily "bolt on" additional feeder funds in due course once the fund builds up a track record.

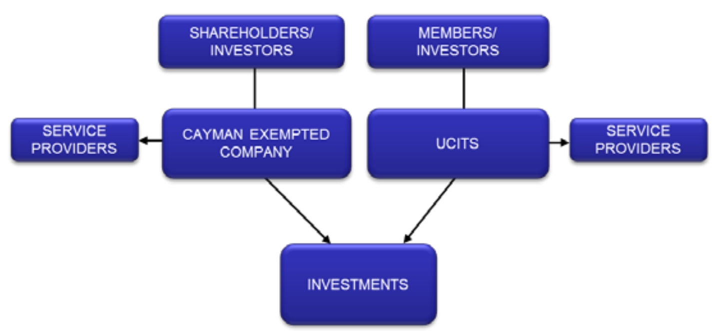
Set out below is a diagram of a typical corporate "single-legged," "one-legged" or "partial" master-feeder hedge fund structure.



Parallel Funds

Parallel funds are funds established to accommodate the needs of different investors, but which invest directly in investments and alongside each other in parallel, rather than into a common master fund which makes direct investments. Parallel funds are particularly useful for fund managers wishing to access investor capital from markets where Cayman vehicles are not the preferred investment vehicle. An example would be in the context of the European retail market where investors often invest through a UCITS (Undertakings for Collective Investment in Transferable Securities) compliant fund. An investment manager wishing to attract investors (including large pension funds) from European markets may choose to establish a UCITS fund for European investors and a Cayman Islands-domiciled fund for the non-European investors. The same investment strategy is employed by both the UCITS funds and the parallel Cayman Islands-domiciled fund.

Set out below is a diagram of a typical parallel hedge fund structure.



Umbrella Funds

An umbrella fund is a framework or platform onto which additional funds are added. Turned upside-down, an umbrella fund looks like an open umbrella, with the principal fund forming the handle and the sub-funds functioning as the umbrella.

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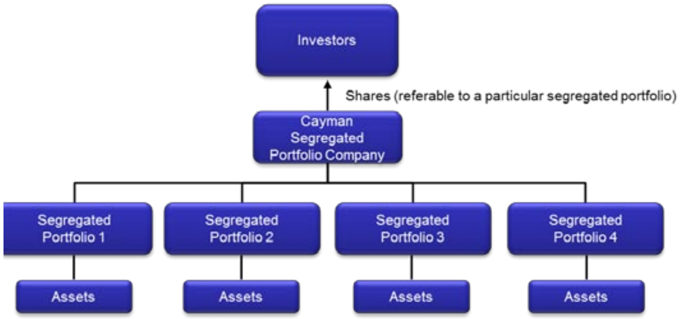
Asia-based fund managers organize two principal types of umbrella funds. An especially popular structure is the unit trust platform, which is a type of umbrella fund that is generally established by institutional banks in Japan to attract Japanese investors. The first step in establishing this type of umbrella fund is to establish one master trust (which may or may not in fact be a trust for the purposes of Cayman Islands trust law), which is essentially a master bundle of rights set out in a unilateral declaration of trust by the trustee or bilateral trust deed (between the trustee and the investment manager). Sub-funds, which are invariably trusts for the purposes of Cayman Islands trust law, are then established from time to time under the powers given to the trustee (and investment manager, where applicable) in the master trust document. Each sub-fund may have a separate investment manager and will operate a different investment strategy within the framework of the umbrella platform.

Another popular type of umbrella fund utilized by Asia-based fund managers is the Cayman Islands segregated portfolio company. A Cayman Islands segregated portfolio company is a type of Cayman Islands exempted company which can create and operate one or more segregated portfolios with the benefit of statutory segregation of assets and liabilities between portfolios. Each portfolio is operated as a separate "sub-fund" and may be managed by a separate fund manager or employ a different investment strategy from other segregated portfolios of the same company. See "Cayman Court of Appeal Holds that Soft Wind-Down of One or More Segregated Portfolios of a Segregated Portfolio Company Does Not In and Of Itself Justify a Judicial Winding-Up of the Entire Company," The Hedge Fund Law Report, Vol. 5, No. 23 (Jun. 8, 2012). However, each sub-fund will not be entitled to be classified separately for U.S. federal income tax purposes.[2] This may also be the case in other jurisdictions. For instance, it is unclear under Singapore law whether each cell in a segregated portfolio company would be regarded as a separate taxable entity. The current position appears to be that tax incentives (and the qualifying criteria for such tax incentives) are applied on a company-wide basis.

The advantages of using an umbrella structure over traditional hedge fund structures include reduced complexity in establishing multiple funds, cost savings and a more streamlined offering for multiple sub-funds. However, as noted above, one disadvantage, as compared to comparable U.S. domestic entities, is a lack of flexibility in U.S. federal income tax classifications between cells.

Set out below is a diagram of a typical umbrella fund structured as a segregated portfolio company. If the above structure were set up utilizing a unit trust structure, there would also need to be a trustee in relation to each of the sub-funds.



Singapore Master Fund/Trading Subsidiaries

In recent years, there has been an increasing trend in Singapore towards the establishment of Singapore-domiciled trading subsidiaries or investment vehicles, either below the "master fund" in a master-feeder structure, or as the master fund itself in the master-feeder structure.

The key reason for setting up such a trading subsidiary or master fund is to provide access to the numerous double taxation treaties which Singapore has entered into with various countries, such as India, China, Korea, Australia, Hong Kong, Japan, United Kingdom and Switzerland. These treaties provide various benefits to Singapore-based businesses, such as reduced withholding tax and capital gains tax.

As most of these double taxation treaties provide for the benefits of the treaty to be available to corporate entities only, the trading subsidiary or master fund is invariably structured as a limited liability company, rather than a trust or a limited partnership.

It should, however, be noted that there are certain drawbacks to using a Singapore limited liability company as a fund vehicle. For example, the number of shares held by any shareholder of a Singapore company and the shareholder's name must be provided to the Accounting and Corporate Regulatory Authority of Singapore (ACRA), and may be discovered by any member of the public through paid searches on the ACRA's database. Also, there is no concept of segregated portfolios within the Singapore company structure.

Further, audited financial statements of the company must also be filed with the ACRA on an annual basis. As the Singapore company's accounts must be prepared in accordance with the Singapore Financial Reporting Standards, certain accounting treatments used in the preparation of the company's financial statements may be at variance with the International Financial Reporting Standards or U.S. GAAP.

There are also certain difficulties with distributions and the payment of redemption proceeds by a Singapore fund vehicle that is structured as a company. A Singapore company may declare dividends out of profits only, not capital. A Singapore company is also prohibited by the Companies Act (Cap. 50) of Singapore from redeeming preference shares or from repurchasing its own shares, if it is unable to satisfy a prescribed solvency test. This solvency test requires that (1) the company's assets not be less than its liabilities (including contingent liabilities) at the time of or after the redemption or repurchase, and (2) the company will be able to pay its debts as they become due during the period of 12 months immediately following the date of issue of a solvency statement by the directors of the company confirming that the company has met the requirements of the solvency test.

Additionally, the fund manager's fees, if charged to the Singapore trading subsidiary or master fund, must carry goods and services tax (currently charged at a rate of 7 percent). There is however a goods and services tax remission scheme that is available to funds managed by Singapore investment managers, which allows the fund to claim up to 93 percent of goods and services tax paid to the investment manager, from the Singapore taxation authorities.

Nevertheless, despite the above difficulties, a Singapore corporate fund vehicle has steadily grown in popularity due to a combination of the double taxation treaty benefits and various tax incentives promulgated by the Monetary Authority of Singapore (MAS), which exempts qualifying corporate fund vehicles which are managed by Singapore investment managers from income tax on a wide range of investments.

The factors described above have resulted in the Singapore entity being, in most cases, structured as a trading subsidiary or master fund, rather than as a stand-alone fund in which investors would directly invest.

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www.hflawreport.com Volume 5, Number 31 August 9, 2012

Common Management Structures

Important considerations in settling the overall hedge fund structure will include deciding where the management entity will be domiciled and how management fees will be paid to ensure optimal taxation efficiencies in the applicable jurisdiction. This is an area which is rapidly changing, generally in response to rules promulgated by the tax authorities in the jurisdiction of the fund manager, and accordingly local regulatory advice is critical at the outset to ensure that the structure is correctly established.

For instance, historically, given the broad permanent establishment rules in Australia, Australian-based managers of Cayman Islands funds went to great lengths to ensure that the management and control of the fund was based in the Cayman Islands. It would be common for the management entity to be a Cayman Islands exempted company (rather than, for instance an Australian entity), the shares of which would be held by a Cayman Islands charitable trust or STAR trust. The fund would delegate full discretionary management to the management company which would retain most of the discretionary management function, and delegate primarily "advisory" functions to a licensed Australian advisory company. With recent changes to the Australian taxation rules, this common structure slowly is being replaced with the direct appointment of an Australian licensed investment management entity.

In Singapore, there is a similar trend towards the direct appointment of the Singapore-domiciled management entity due to the establishment of various tax incentives for fund managers in Singapore and an increased focus on transfer pricing issues between the Cayman Islands management entity and the Singapore-based manager.

For Hong Kong-based managers (which includes managers from mainland China that set up operations in Hong Kong to take advantage of the stability and legitimacy of the legal structure and regulatory environment), the structure of choice is to use a Cayman Islands exempted company as the manager and to delegate management functions to a Hong Kong-licensed entity. Generally, the bulk of management and performance fees are held in the Cayman Islands entity, with the Hong Kong entity being remunerated on a costs-plus basis (with the spread over cost representing approximately 5 percent). It is also becoming increasingly common for the Hong Kong advisory company to be paid on a profit split or revenue split basis. Commonly, fees are repatriated to Hong Kong through the payment of dividends from the Cayman Islands management entity given the favorable tax treatment of dividends as compared to income.

Cayman Islands Mutual Fund Regulation

In establishing a fund domiciled in the Cayman Islands, it is important to be aware of the Cayman Islands mutual fund regime which is primarily regulated under the Mutual Funds Law of the Cayman Islands (Mutual Funds Law). The regulator of mutual funds in the Cayman Islands is the Cayman Islands Monetary Authority (CIMA).

The Mutual Funds Law defines a "mutual fund" as "a company, unit trust or partnership that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors in the mutual fund to receive profits or gains from the acquisition, holding, management or disposal of investments." For these purposes, an "equity interest" is defined as "a share, trust unit or partnership interest that (a) carries an entitlement to participate in the profits or gains of the company, unit trust or partnership and (b) is redeemable or repurchasable at the option of the investor . . . before the commencement of winding up or dissolution of the company . . . but does not include debt."

Accordingly, two key elements which will result in a fund being subject to the Mutual Funds Law are:

1. The pooling of assets (meaning that single investor funds are not subject to regulation under the Mutual Funds Law); and
2. The option for investors to redeem.

The Mutual Funds Law makes it clear that debt-issuance vehicles do not fall within its scope, unless they also issue relevant equity interests.

The vast majority of Cayman Islands hedge funds are regulated under the Mutual Funds Law. There are three categories of regulated mutual funds in the Cayman Islands, and in addition, Cayman Islands-domiciled master funds are now also required to be registered as mutual funds (see "Master Fund Registration" below). Regulation under the Mutual Funds Law will apply equally regardless of the type of fund vehicle utilized.

The three categories are as follows:

1. *Licensed Funds* – Licensed funds are funds which hold a license under the Mutual Funds Law and are generally established as retail funds as there is no minimum investment threshold. These funds must have either a registered office in the Cayman Islands or, if a unit trust, a trustee which is licensed under the Banks and Trust Companies Law of the Cayman Islands and are subject to a prior approval process, requiring CIMA to be satisfied with the experience and reputation of the promoter and administrator and that the business of the fund and the offering of its interests will be carried out in a proper way. This type of fund is relatively rare, although has been popular with managers making public offerings to the Japanese retail market. The Retail Mutual Funds (Japan) Regulations of the Cayman Islands will also apply in relation to most licensed mutual funds which intend to make an offering to the public in Japan. These regulations impose additional reporting and compliance obligations on such funds.
2. *Administered Funds* – Similar to licensed funds, administered funds have no minimum investment threshold and as such are generally established to target retail investors. These funds must have a licensed mutual fund administrator providing their principal office in the Cayman Islands (as distinct from funds falling in the third category below which can have an administrator outside the Cayman Islands). Given the usual hedge fund investor profile, funds regulated in this manner are fairly rare.
3. *Regulated Funds* – This category is the most commonly used type of mutual fund for hedge fund purposes and is generally targeted at sophisticated investors. To fall into this category funds must either: (1) have a minimum subscription amount by any prospective investor of at least US$100,000 or equivalent; or (2) the equity interests must be listed on an approved stock exchange or over the counter market, which has been approved by CIMA. No approval from CIMA is required prior to the launch of such a fund.

To illustrate the proportion of mutual funds in each category (and including master funds, discussed below), CIMA's published statistics indicate that, as of June 30, 2012, of the 10,871 mutual funds registered in the Cayman Islands, 123 are licensed funds; 418 are administrated funds; 8,598 are regulated funds; and 1,732 are master funds.

Ongoing Compliance Requirements

All regulated mutual funds are required to produce an offering document and to have appointed an approved auditor in the Cayman Islands and an administrator. Regulated funds are required to file their audited accounts with CIMA within six months of the end of each financial year.

Unregulated Funds

An exemption exists from the registration requirements discussed above, in relation to funds which meet the definition of a "mutual fund" under the Mutual Funds Law, but which are intended for placement on a limited or private basis.

The exemption applies where the equity interests in the fund in question are held by not more than fifteen investors, the majority of whom are capable of appointing or removing the "operator" (which means the trustee, general partner or directors – depending on the structure of the relevant vehicle) of the fund. Such a fund is outside the scope of the Mutual Funds Law and therefore sometimes referred to as an "unregulated" fund in the Cayman Islands.

Historically, master funds in master-feeder structures have been structured to take advantage of this exemption, although, as discussed below, recent amendments to the Mutual Funds Law have introduced the requirement for master funds to be registered as mutual funds.

Master Fund Registration

The Mutual Funds Law was amended in December 2011 with the intention of extending the regulation of Cayman Islands mutual funds to require master funds to be registered and regulated in the same manner as regulated feeder funds.

A "master fund" is defined under the amended Mutual Funds Law as a "mutual fund that is incorporated or established in the Cayman Islands that holds investments and conducts trading activities and has one or more regulated feeder funds." A "regulated feeder fund" is in turn defined as a regulated mutual fund that conducts more than 51 percent of its investing through another mutual fund."

Accordingly, for a master fund to be *subject* to registration under the amended Mutual Funds Law, it must, among other things, satisfy the definition of a "mutual fund." It is therefore arguable that a master fund in a single-legged master feeder structure is not a "mutual fund" regulated under the Mutual Funds Law as such master fund will have only a single investor (i.e., the regulated feeder fund) and will not have the element of pooling of investor funds required to satisfy the definition of a mutual fund. To address this technical loophole, CIMA has issued a written statement confirming that the intention of the Cayman Islands Government is that all master funds with one or more regulated feeder funds would be registered with CIMA. However, notwithstanding this statement, as at the date of publication of this article, the Cayman Islands Government has deferred further amendments to the definition of "master fund" in the Mutual Funds Law pending further consultation with industry.

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www.hflawreport.com Volume 5, Number 31 August 9, 2012

Anti-Money Laundering Requirements – Choice of Administrator

Under the Money Laundering Regulations (as amended) of the Cayman Islands, as supplemented by the Guidance Notes issued by CIMA (together, the Regulations), a Cayman Islands fund may choose to comply with the Regulations by appointing an administrator which is either (1) regulated in a "Schedule 3" country AND subject to the anti-money laundering (AML) regime of that country; or (2) applying the Cayman Islands laws and procedures. If (1) above applies, the administrator may apply the AML regime of the applicable Schedule 3 jurisdiction to prospective investors in the fund, and the fund will by default satisfy its Cayman Islands obligations under the Regulations.

"Schedule 3" countries are those countries listed in Schedule 3 of the Regulations to the Proceeds of Crime Law of the Cayman Islands, being countries and territories regarded as having equivalent legislation to that of the Cayman Islands. Relevant to funds based in the Asia Pacific region, Schedule 3 countries include Australia, Hong Kong and Singapore. Unfortunately, administrators in Australia, Hong Kong and Singapore are neither regulated (in the capacity as administrators) in these countries nor subject to the AML regime of these countries, and will generally apply the AML regime of the particular country on a voluntary basis.

There is an exception to the rule above in relation to Singaporean administrators, where the administrator also acts as custodian to the fund. In this case, they will be regulated (although in the capacity of custodian), and will be mandatorily subject to the AML regime of Singapore. In addition, an administrator that is a regulated financial institution, such as a bank, will also be excepted from the rule above and will thus be regulated (in its capacity as a bank) and subject to the applicable AML regime in that capacity.

Accordingly, where a Cayman Islands domiciled fund managed by an Asia-based fund manager appoints an administrator in Australia, Hong Kong or Singapore, unless one of the exceptions noted above applies, the fund will need to be very careful to ensure at the outset that the administrator is equipped to apply the Cayman Islands AML Regulations in relation to prospective investors. Otherwise the fund will be in breach of Cayman Islands law.

Conversely, as fund managers based in Singapore are subject to the AML regime of Singapore, an Asia-based fund manager would also need to consider whether the administrator would be able to assist the fund manager in obtaining the necessary documents and conducting the requisite due diligence checks to satisfy the Singapore AML regime.

Corporate Governance

It has long been a common practice among Asia-based fund managers for "friends and family" to be appointed as fund directors, especially in the very early stages of a fund's life where cost control is paramount. Fund managers looking to establish funds on this basis should consider the recent judgment of the Cayman Islands Grand Court in the case of *Weavering Macro Fixed Income Fund Limited (In Liquidation) v Stefan Peterson and Hand Ekstrom*, which reaffirmed the legal framework within which directors of Cayman Islands domiciled hedge funds must operate and, on its unique facts, is a clear example of errant and delinquent directors being held personally liable for losses caused by their inactivity and failure to satisfy their high-level supervisory role. See "Cayman Grand Court Holds Independent Directors of

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www.hflawreport.com Volume 5, Number 31 August 9, 2012

Failed Hedge Fund Weavering Macro Fixed Income Fund Personally Liable for Losses Due to their Willful Failure to Supervise Fund Operations," The Hedge Fund Law Report, Vol. 4, No. 31 (Sep. 8, 2011).

In this case, the Court found that the defendant directors were each fully liable to Weavering Macro Fixed Income Fund Limited (In Liquidation) for US$111 million in damages for losses caused by the directors' wilful neglect or default of their duties.

Although the case does not create new law, by highlighting the directors' failure to act, it defines and clarifies the Court's expectations as to the policies and good governance procedures that a hedge fund director should consider adopting in order to satisfy his/her expected duty of skill, care and diligence.

This case should be viewed in light of its unique facts, and the Court's decision reaffirms that it will not look to import liability where directors, acting in a bona fide manner, have made a business decision which they determine to be in the interests of a fund. Directors, however, must be able to demonstrate that they have acted in a bona fide manner in satisfying their duties, including acting independently of any conflicts they may have with respect to other service providers of the fund; making due inquiry with respect to reports and agreements; and ensuring that there is appropriate evidential support (including fair and accurate minutes from board meetings) which support the decisions made by the directors. In the absence of clear or undisputed evidence, the Court may consider directors' standards of conduct over the term of their appointment as otherwise being indicative of such matters.

There is a growing awareness of the importance of strong corporate governance in Asia, especially in relation to hedge fund investments. Institutional hedge fund investors in Asia are now conducting extensive and long term due diligence of funds, managers and boards that they are seeking to invest in, and Asian regulators are beginning to require fund managers to implement minimum governance standards. To satisfy institutional investor requirements, governance structures need to be efficient and effective, and the board composition should be tailored to the investment strategy of the fund. Investors are frequently demanding that hedge funds in which they invest have boards that have a majority of independent directors.

Considerations for Singapore-Based Investment Managers

Investor Suitability Requirements

Under Singapore securities laws, any person who carries on business in fund management in Singapore must either obtain a license to do so or invoke an exemption from such licensing requirements.

A vast majority of investment managers operating in Singapore have invoked an exemption which allows the investment manager to manage funds for up to 30 "qualified investor" clients, due to the hitherto lighter compliance regime for exempt fund managers. A "qualified investor" includes an open-ended investment fund which is offered only to "accredited investors" (as defined under the Securities and Futures Act (Cap. 289) of Singapore), or investors in an equivalent class under the laws of the country or territory in which the offer is made.

The definition of "accredited investor" in the Securities and Futures Act of Singapore includes the following categories of persons:

1. An individual (i) whose net personal assets exceed in value SGD 2 million (or its equivalent in a foreign currency) or such other amount as the MAS may prescribe in place of the first amount or (ii) whose income in the preceding 12 months is not less than SGD 300,000 (or its equivalent in a foreign currency) or such other amount as the MAS may prescribe;
2. A corporation with net assets exceeding SGD 10 million in value (or its equivalent in a foreign currency) or such other amount, as determined by (a) the most recent audited balance sheet of the corporation; or (b) where the corporation is not required to prepare audited accounts regularly, a balance sheet of the corporation certified by the corporation as giving a true and fair view of the state of affairs of the corporation as of the date of the balance sheet, which date shall be within the preceding 12 months; and
3. The trustee of a trust of which all property and rights of any kind whatsoever held on trust for the beneficiaries of the trust exceed SGD 10 million in value (or its equivalent in a foreign currency), when acting in that capacity.

Singapore-based investment managers should note that the above definitions differ in some respects from the definition of "accredited investor" as that term is defined under Regulation D of the U.S. Securities Act of 1933 (Securities Act). For example, the net worth and income threshold for natural persons is higher than that set out in the Securities Act. See "Implications for Hedge Fund Managers of the Rule Amendments Recently Adopted by the SEC to Raise Accredited Investor Standards," The Hedge Fund Law Report, Vol. 5, No. 1 (Jan. 5, 2012).

While a Singapore investment manager seeking to raise funds from U.S. resident investors may rely on the definition of "accredited investor" under the Securities Act on the basis that that is an "equivalent class," in the event that the units of a fund managed by a Singapore investment manager which has invoked the exemption mentioned above are offered to a U.S. investor outside of the U.S., the definition of "accredited investor" under the Securities Act would not be applicable since the offer was made outside the U.S. Singapore investment managers utilizing the 30 "qualified investor" licensing exemption should therefore be mindful of these requirements when approaching U.S. investors who are resident outside of the United States. Singapore investment managers should also be aware that the "qualified investor" requirement (and by extension, the "accredited investor" requirement applicable to the investors in the "qualified investor") applies at all times during the period for which such investor is invested in the fund.

Investment managers looking to establish a presence in Singapore should also note that the MAS has since April 2010 been issuing a number of proposals to revamp the regulatory regime for fund management companies in Singapore, and has recently announced that it expects to implement these changes in August 2012. Amongst these changes are proposals to refine the 30 "qualified investor" licensing exemption, to allow "qualified investor" funds to be offered to "institutional investors" as well. "Institutional

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www.hflawreport.com Volume 5, Number 31 August 9, 2012

investors" include persons who are Singapore registered banks, finance companies, broker-dealers, insurance companies and trust companies, as well as pension funds. While this would to some extent expand the scope of the exemption, there are other constraints which would be placed on a Singapore investment manager utilizing this licensing exemption, such as a restriction stating that no more than 15 of the 30 "qualified investors" may be investment funds, and enhanced regulatory capital and compliance obligations imposed on the investment manager.

Anti-Money Laundering and Disclosure Requirements

Singapore-based investment managers are subject to anti-money laundering and counter-terrorism financing regulations. These regulations impose a strict standard of customer due diligence which the investment manager must perform on its clients and their beneficial owners. These include a requirement to verify the identity of the client and its beneficial owners using independent sources; to monitor the conduct of transactions in the client's accounts on an ongoing basis; and to report suspicious transactions to the Commercial Affairs Department of Singapore or the Commissioner of Police.

The investment manager may also be required to disclose information on various persons who are invested in the funds it manages, without "tipping off" such persons. This may place the investment manager at odds with common practices with regard to the confidentiality of customer information as well as U.S. privacy rules (to be discussed in Part 2 of this series). Singapore investment managers should be mindful of these confidential disclosure and reporting requirements and provide for suitable and adequate rights to information and disclosure when preparing the fund documents.

Prohibited Representations by Exempt Fund Managers

As investors increase their due diligence efforts on funds and their investment managers prior to making an investment, a common question asked of investment managers is the regulatory status of the investment manager, i.e., whether the investment manager is regulated in its home jurisdiction or otherwise. In this regard, Singapore investment managers who have invoked the 30 "qualified investor" rule should note that they are prohibited from representing themselves as being licensed, regulated, supervised or registered by the MAS, whether verbally or in writing. This may restrict the Singapore investment manager's ability to market its fund outside Singapore, as certain investors, in particular U.S. institutional investors, may prefer that the investment manager be licensed rather than exempt.

Notwithstanding the foregoing, in April 2010, the MAS commenced a public consultation exercise on a proposed review of the regulatory regime for fund managers in Singapore, and one of the features discussed in a follow-on consultation paper issued by the MAS in September 2011 was a proposed change of nomenclature of the exempt fund manager category described above, from "exempt fund manager" to "Registered Fund Management Company," which would likely mean that a "Registered Fund Management Company" would be able to represent that it is registered with the MAS.

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The definitive source of actionable intelligence on hedge fund law and regulation

www.hflawreport.com Volume 5, Number 31 August 9, 2012

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[1] A trustee may also be one or more individuals or a corporation from a jurisdiction other than the Cayman Islands.

[2] The U.S. Internal Revenue Service (IRS) recently provided in proposed regulations that each "series" in a Delaware series limited liability company (a form of entity similar to a Cayman Islands segregated portfolio company) may elect a different tax classification (e.g., Series A could be taxed as a corporation and Series B could be taxed as a partnership for U.S. federal income tax purposes); however, the IRS has limited this treatment to only domestic entities. Thus, each cell in a Cayman Islands segregated portfolio company must be treated the same for U.S. federal income tax purposes.

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www.hflawreport.com Volume 5, Number 32 August 16, 2012

Asia

Structuring, Regulatory and Tax Guidance for Asia-Based Hedge Fund Managers Seeking to Raise Capital from U.S. Investors (Part Two of Two)

By Peter Bilfield, Todd Doyle, Lu Yueh Leong and Michael Padarin

Over the past several years, U.S. investors have broadened their alternative investment horizons by exploring investment opportunities with Asia-based fund managers. Asia-based fund managers provide a unique perspective on alternatives which translates to differing investment strategies that appeal to U.S. investors seeking uncorrelated returns or "alpha." Nonetheless, Asia-based fund managers that seek to attract U.S. investor capital must recognize the intricate regulations that govern investment manager and fund operations in the U.S. and other jurisdictions, such as the Cayman Islands where many funds are organized to attract U.S. investors.

This is the second article in a two-part series designed to help Asia-based fund managers navigate the challenges of structuring and operating funds to appeal to U.S. investors. This article describes in detail a number of the key U.S. tax, regulatory and other considerations that Asia-based fund managers are concerned with or should consider when soliciting U.S. taxable and U.S. tax-exempt investors. The first article described the preferred Cayman hedge fund structures utilized by Asia-based fund managers, the management entity structures, Cayman Islands regulations of hedge funds and their managers and regulatory considerations for Singapore-based hedge fund managers. See "Structuring, Regulatory and Tax Guidance for Asia-Based Hedge Fund Managers Seeking to Raise Capital from U.S. Investors (Part One of Two)," The Hedge Fund Law Report, Vol. 5, No. 31 (Aug. 9, 2012).

U.S. Tax Considerations

As discussed in the previous article in this series, the favored choice for structuring funds for Asia-based fund managers has been, and continues to be, a Cayman Islands exempted company. When structuring a Cayman Islands domiciled fund, Asia-based investment managers seeking to solicit U.S. persons must carefully weigh U.S. investors' concerns regarding potential tax liabilities against foreign investors' desire to avoid ongoing reporting obligations to the U.S. Internal Revenue Service (IRS). Non-U.S. investors tend to favor corporations which are easily understood by non-U.S. investors. In addition, organizing the corporation in a tax haven jurisdiction, such as the Cayman Islands, allows non-U.S. shareholders to defer income in their home jurisdiction until disposition of their shares in the fund (although as described in the previous article, many Asia-based fund managers also utilize Cayman Islands domiciled unit trusts).[1] In addition, so long as the fund does not engage, directly or indirectly, in a U.S. trade or business, the Cayman Islands domiciled fund will not have to file a U.S. tax return, a primary concern among Asia-based fund managers and their foreign investors who seek to not only maintain their anonymity with the United States government, but also to avoid undertaking any tax obligations to the IRS.

Against this backdrop, Asia-based fund managers must also address the legal issues facing prospective investors that are "United States Persons." A United States Person is typically defined to include, (1) with respect to individuals, any U.S. citizen (and in some instances former U.S. citizens) or "resident alien"[2] within the meaning of the Internal Revenue Code of 1986, as amended (Code); and (2) with respect to persons other than individuals (A) a corporation, partnership or limited liability company created or organized in the United States or under the laws of the United States (B) a trust where (x) a United States court is able to exercise primary supervision over the administration of the trust; (y) one or more U.S. persons have the authority to control all substantial decisions of the trust; or (z) the trust was in existence on August 20, 1996, was treated as a U.S. trust, and made an election to continue its treatment as a U.S. trust pursuant to the Code; and (C) an estate which is subject to U.S. tax on its worldwide income from all sources.

Investors that are United States Persons may be separated into two categories: U.S. taxable investors and U.S. tax-exempt investors, and each category of United States Person has its own set of distinct issues and concerns when investing in a non-U.S.-domiciled entity.

U.S. Tax-Exempt Investors and UBTI

U.S. tax-exempt investors (generally foundations, endowments, not-for-profit charitable and educational institutions and pensions), defined as United States Persons that are exempt from payment of U.S. federal income taxes, prefer to invest in Cayman Islands exempted companies. U.S. tax-exempt investors seek to avoid investments in funds that are taxed as U.S. partnerships for federal income tax purposes, primarily because the income of a partnership will be "passed through" to the tax-exempt investor, and the fund's direct or indirect activities may generate "unrelated business taxable income" or "UBTI"[3] which will flow through to the U.S. tax-exempt investor. Under the default classification rules applicable to non-U.S. entities, where each member of an entity has limited liability for the obligations of the entity, then, absent an affirmative election to be classified differently, that entity, such as a Cayman Islands exempted company, will be treated as an association taxable as a corporation for U.S. federal income tax purposes. Generally, UBTI is income derived from a trade or business that is not substantially related to the performance of the U.S. tax-exempt investor's organizational purpose or function. Passive income, such as dividends, interest or capital gains are excluded from the definition of UBTI, unless such income is traceable to an investment where there was "acquisition indebtedness," (e.g., leverage). Not all sources of leverage would be deemed acquisition indebtedness, but margin to purchase securities would be a form of such indebtedness. Although U.S. tax-exempt investors generally are exempt from U.S. federal income taxes, they will be subject to tax on UBTI and may be required to report such income on their annual filings with the IRS. If the U.S. tax-exempt investor is a charitable remainder trust, the receipt of UBTI has a potentially more dire effect because such trust will be subject to a 100% excise tax. Finally, U.S. tax-exempt investors that generate significant UBTI on an ongoing basis are at risk of losing their tax-exempt status. Typically, a U.S. tax exempt investor avoids UBTI by investing in an offshore entity that is taxed as a corporation for U.S. tax purposes. The corporation acts as a "blocker" shielding the U.S. tax-exempt shareholders from UBTI on investment income.[4] Consequently, U.S. tax-exempt investors seek to avoid UBTI not only to avoid incurring federal income tax liability, including liability for certain excise taxes, but also, in more extreme cases, to prevent the loss of their tax exempt status.

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www.hflawreport.com Volume 5, Number 32 August 16, 2012

U.S. Taxable Investors

PFIC Funds

On the other hand, U.S. taxable investors prefer to invest in domestic funds (generally partnerships) as a result of several U.S. tax rules, with some exceptions. First, investments by U.S. taxable investors in foreign corporations trigger the passive foreign investment company or "PFIC" rules.[5] The PFIC rules were established in the 1980s to combat the use of foreign companies by U.S. investors to defer taxes and convert the character of fund income from ordinary income to capital gains. A PFIC is defined to include a foreign corporation considered to own, directly or indirectly, 75% or more of passive income or at least 50% of passive assets. Hedge funds organized outside the United States and classified as corporations for federal income tax purposes generally will be PFICs. A U.S. investor who holds shares in a PFIC is subject to special rules regarding "excess distributions" (which include both certain distributions made by a PFIC and any gain recognized on the disposition of PFIC shares). In general, the amount of any excess distribution will be deemed to be earned ratably over the period in which the PFIC shares were owned. All excess distributions are taxable at ordinary income rates, and, with respect to income allocable to prior years, the deferred tax will be imposed at the highest rate of tax applicable to that year and will be increased by an interest charge, as though the amount of tax allocable to prior years was overdue.

The punitive provisions applicable to PFICs may be avoided if the U.S. taxable investor makes a qualifying electing fund (QEF) election with respect to its PFIC stock. Once a QEF election is made, the U.S. taxable shareholder will be taxed in a manner similar, although not identical, to the way it would be taxed if it had invested in a U.S. partnership, paying tax currently and with the same character of income. Disposition of the shares in the QEF fund would result in capital gains treatment. QEF-eligible funds are not as common a structure for U.S. taxable investors as are pass-thru-type funds. In order for a shareholder to make a QEF election, the fund must consent to the election, and the U.S. shareholder will have an affirmative obligation to provide the IRS annually with certain financial information relative to the fund's income and activities on the U.S. shareholder's federal income tax return. This filing requirement triggers a collateral requirement on the fund's part to adhere to certain U.S. income tax principles in calculating its annual earnings and profits, which principles may run counter to international financial reporting standards, the accounting standard utilized by many non-U.S. investment managers. As such, the fund may be required to maintain two sets of financial statements in order to accommodate the U.S. shareholders making the QEF election.

These record-keeping requirements typically result in an additional annual expense (which may include additional administrative costs). The additional expense may be borne by the fund manager or the shareholders, depending on the relative bargaining power of the parties. If the fund elects to charge the shareholders for such annual cost, it is advisable to segregate the electing shareholders in a separate share class so that only similarly situated shareholders (i.e., QEF electing shareholders) bear the cost of such election without any cost attributed to non-electing shareholders in other share classes. If the fund manager elects to initially bear the cost of such election, in whole or in part, it is advisable to provide flexibility in the offering documents to allow the manager to seek reimbursement in the future and allocate the cost at its sole discretion pro-rata among the electing shareholders;

typically, such allocation will occur at a time when the fund reaches a critical mass of QEF electing shareholders where such cost allocation would be incremental to each such electing shareholder. Asia-based fund managers should carefully weigh this option before undertaking to solicit U.S. taxable investors into a PFIC fund. Even if the Asia-based fund manager is amenable to producing the appropriate financial statements for its U.S. taxable investors, many U.S. taxable investors are still reticent to invest in a PFIC fund which would require them to attach the financial statements of the PFIC fund to their U.S. tax returns.

Application of the Controlled Foreign Corporation (CFC) Rules

Even if U.S. taxable shareholders make a QEF election, and the fund consents to such election, Asia-based fund managers still must be aware of the effects of the controlled foreign corporation or "CFC" rules. A CFC is any foreign corporation of which more than 50% of its stock (by vote or value) is owned by "U.S. shareholders." For purposes of the CFC rules, a "U.S. shareholder" is defined to include only those U.S. persons owning, directly or indirectly, 10% or more of the stock (by vote) of the CFC. If the offshore fund is deemed a CFC, the U.S. taxable investors will have to include currently as ordinary income their pro-rata share of the CFC's so-called "Subpart F" income, which generally includes passive income such as dividends, interest and capital gains. Such income is taxed as ordinary income and it is taxed regardless of whether it has been distributed. U.S. tax exempt investors will not be subject to taxation as a result of the fund's CFC status, but will be required to report such income on their annual informational return with the IRS. As a result of the complexities triggered by the PFIC and CFC regimes, many practitioners advise Asia-based fund managers to create a separate U.S.-domiciled fund for the benefit of U.S. taxable investors (either as a feeder fund in a master-feeder structure or in parallel with a separate Cayman Islands exempted company established to accept subscriptions from foreign investors).

One-Legged Master Feeder Structures – U.S. Tax Implications

In an effort to minimize the number of entities and the organizational costs involved with launching a fund, many non-U.S. fund managers will form a "one-legged" master-feeder structure. The master fund (taxed as a partnership for U.S. federal income tax purposes) accepts subscriptions not only from U.S. taxable investors directly, but also from a feeder fund organized as a Cayman Islands exempted company (taxed as a corporation for U.S. federal income tax purposes) in which U.S. tax-exempt and foreign investors invest. U.S. taxable investors avoid the PFIC rules, and tax-exempt U.S. investors avoid UBTI by investing through a "blocker" corporation. In addition, non-U.S. investors avoid certain disclosure requirements which may be applicable to an investment directly into a partnership).[6] The structure also reduces upfront and annual administrative burdens and costs associated with managing multiple "active investment" entities, such as a U.S. feeder fund (e.g., tax, administration, legal and audit costs). However, as described below, the informational and withholding requirements of FATCA (defined below) may prove too burdensome to a non-U.S. investment manager to continue the use of a one-legged master feeder structure with multiple U.S. beneficial owners as shareholders at the master fund level.

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www.hflawreport.com Volume 5, Number 32 August 16, 2012

Disclosure and Reporting Requirements Applicable to U.S. Investors in Non-U.S. Funds

U.S. investors historically have been required to report to the IRS their investments and interests in non-U.S. funds. These requirements have increased in recent years, requiring U.S. investors to file a Report of Foreign Bank and Financial Accounts (FBAR) annually with the United States Department of the Treasury, as well as sometimes redundant reports to the IRS (i.e., Forms 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations; Form 926, Return by U.S. Transferor of Property to Foreign Corporations; Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships; etc.)

Most recently, the United States passed the Foreign Account Tax Compliance Act of 2010 (FATCA), which will have far-reaching implications for investors and fund managers alike.

FATCA is intended to apply to every foreign financial institution (FFI), including non-U.S. investment funds engaged primarily in investing, re-investing or trading securities or partnership interests for its own account. FFIs may have to register with the IRS beginning in 2013 and enter into an agreement with the IRS to become a "registered FFI." Registered FFIs will be required in the agreement with the IRS to collect and provide annually certain identifying information about its U.S. beneficial owners holding $50,000 or more in any such FFI as well as information account balances and, beginning in 2016, information regarding income paid or credited to a U.S. owner's account. As a result of the foregoing, a two-prong master fund would be subject to a significantly more burdensome reporting effort, requiring the collection of identifying information on each U.S. taxable investor investing directly into the master fund, whereas an investment manager in a traditional master-feeder structure will only have to collect identifying information from the U.S. feeder fund. So-called "recalcitrant shareholders," that have failed to provide certain identifying information to the FFIs as to their status as U.S. persons upon request must also be reported annually. Registered FFIs also are required to withhold on payments to recalcitrant shareholders.

Beginning in 2014, FATCA generally requires payors of U.S. source income (including gains) to withhold 30% of such payments made to any FFI other than a registered FFI. Alternatively, certain FFIs may be granted "deemed compliant" status and thereby avoid withholding on U.S.-source "withholdable payments," provided that their only beneficial owners are themselves either U.S. persons, registered FFIs (or deemed compliant FFIs), or certain exempt beneficial holders such as sovereign governments and their agencies, and the fund certifies that it will withhold on payments to investors in accordance with the FATCA requirements described below.

Beginning in 2014, FFIs that are neither registered nor deemed compliant will be subject to mandatory U.S. income tax withholding on payments of U.S. source dividends, interest and gross disposition proceeds (i.e., gains). Furthermore, beginning in 2017, the FATCA withholding rules may require an FFI that holds U.S. assets directly or indirectly to withhold on (or to be itself subject to withholding upon) certain pass-thru payments it receives for the benefit of its members or account holders that are neither registered nor deemed compliant (so-called "nonparticipating" FFIs). In some instances, the rate of withholding will be determined with reference to the ratio of compliant and non-compliant account holders which ratio is used to determine a withholding percentage applicable to all payments to that account holder (not only payments of U.S. source income). Accordingly, an FFI may be required to withhold on (or itself to be withheld upon) a pass-thru payment even though the source of a particular pass-thru payment has little or no connection to the U.S.

As described above, the application of FATCA to Asia-based fund managers imposes a number of administrative and financial burdens. First, in order to avoid withholding (applicable to gains, interest, dividends and other so-called "fixed determinable and periodic" (FDAP) income), an investment fund will be required to conduct extensive due diligence to determine the extent to which any of its investors may be U.S. persons. This could be especially burdensome to existing funds that have been in place prior to the adoption of the anti-money laundering (AML) and know-your-customer (KYC) rules of recent years. In particular, "one-legged" master funds that have accepted U.S. taxable investors directly into the master fund will be required to undertake due diligence on each U.S. account holder. An FFI also must keep its due diligence inquiries current to take into account, for example, estate transfers, transfers in connection with pledged interests and otherwise, which could operate to bring additional (and sometimes unexpected) U.S. beneficial interest holders into a fund. Second, beginning in 2017, the withholding rules applicable to pass-thru payments will take effect. Under these new withholding rules, investors in a non-U.S. feeder fund in a classic master-feeder structure who fail to provide requisite documentation to the feeder fund may jeopardize the ability of the master fund to make any distributions (regardless of whether such distributions are attributable to U.S. sources) to the feeder fund. Alternatively, the noncompliant feeder fund investor could cause income payable to the master fund to be withheld. The further up the chain that withholding occurs, the more investors will be affected. Consider the following example: a non-U.S. master fund has two feeder funds – one feeder fund for non-U.S. investors and U.S. tax-exempt investors, and the other feeder fund for U.S. taxable investors. If the master fund does not enter into an agreement with the IRS and is not a "deemed compliant" FFI, then distributions to it from U.S. sources or from non-U.S. sources from any registered or deemed compliant FFI will be subject to withholding, thus subjecting investors in both feeder funds to withholding upon certain distributions of non-U.S. income.

New funds should include provisions in their subscription agreements and organizational documents to address FATCA requirements such as: (1) authorizing the investment manager to enter into FFI agreements; (2) requiring the fund's owners to provide FATCA-related information; and (3) permitting the fund to remove investors that do not comply with FATCA requirements. Asia-based fund managers will need to consider amending their fund documents to comply with FATCA and consider steps to be taken to comply with the onerous reporting requirements which require FFI agreements to be entered into with the IRS by June 30, 2013 and funds to file with the IRS by September 30, 2014.

U.S. Regulatory Considerations and Developments

Rescission of General Solicitation Ban for Rule 506 Offerings

Pending upcoming rulemaking, Asia-based fund managers should no longer be subject to the rigid general solicitation restrictions for offerings conducted within the United States.

On April 5, President Obama passed the Jumpstart Our Business Startups Act of 2012 (JOBS Act) which, among other things, created a crowdfunding exemption, increased the triggers for registration as a public company and relaxed reporting requirements for smaller companies. Of particular interest to domestic and foreign hedge fund managers, the JOBS Act also rescinded the 80 year old ban on general solicitation applicable to the private placement exemption found in Rule 506 under Regulation D, the often utilized safe harbor exemption from registration of securities for issuers accepting U.S. investors.[7] In the past, non-U.S. investment managers were able to conduct a public offering when soliciting investors outside the United States relying on the exemption from registration under Regulation S of the Securities Act of 1933 (Securities Act) (so long as no directed selling efforts were made in the United States)[8] and at the same time raise capital within the United States pursuant to Regulation D. However, Asia-based fund managers continued to be subject to the ban on general solicitations when conducting an offering within the United States. If the investment manager complied with the requirements of each offering, the Securities and Exchange Commission (SEC) has provided no-action relief from integration of the Regulation D offering with the simultaneous offering made outside the United States under Regulation S. Similar rules apply under the Investment Company Act of 1940 (Investment Company Act). An offshore fund may simultaneously raise capital in the United States in a private offering in reliance on Section 3(c)(1) and 3(c)(7) of the Investment Company Act (certain exclusions from the definition of investment company which specifically require that no public offering be made to U.S. investors) and conduct a public offering directed to foreign investors located outside the United States. The JOBS Act now provides that Regulation D offerings will not be deemed "public offerings" under the "federal securities laws" as a result of a general solicitation, but it is unclear at this time whether that extends to cover the exclusions from the definition of investment company under Sections 3(c)(1) and 3(c)(7).

Assuming no new rulemaking or other guidance to the contrary by the SEC, the practical impact of the removal of the general solicitation prohibition is that private funds will be able to, among other things, issue press releases, be interviewed by the media, communicate information about fund offerings on publicly available websites and social media and place advertisements during the course of fundraising; provided that, for offerings made under Rule 506, sales are made only to accredited investors. In addition, investment managers will also be able to solicit capital from investors with whom they do not have a substantive pre-existing relationship. See "Implications of the JOBS Act for Hedge Fund Managers," The Hedge Fund Law Report, Vol. 5, No. 14 (Apr. 5, 2012). Investment advisers will, however, remain subject to the substantive provisions of the Investment Advisers Act of 1940 (Advisers Act), including the prohibitions against deceptive advertising, and therefore practitioners should caution fund managers to tread carefully as they will remain subject to the substantive provisions of other U.S. federal securities laws related to advertising and other forms of general solicitation.

Title II of the JOBS Act directed the SEC to implement rules to adopt Title II by July 5 (90 days from enactment of the JOBS Act). As of the date of this article, the SEC postponed the implementation and adoption of the Title II rules and issued a Sunshine Act notice announcing Title II rulemaking will be considered at an open meeting scheduled for August 22, 2012. Until the SEC implements such rules, the general solicitation ban remains in effect, which means simultaneous Regulation S and Regulation D offerings are still susceptible to integration into a single public offering.

Investment Adviser Registration Exemptions for Asia-Based Managers

An Asia-based fund manager may be required to register as an investment adviser pursuant to the Advisers Act, unless an exemption from registration is available. With the enactment of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act on July 21, 2010 (Dodd-Frank Act), many hedge fund managers will rely on the private fund adviser exemption promulgated under Rule 203(m)-1. The private fund adviser exemption exempts from registration any investment adviser solely to qualifying private funds that have less than $150 million in regulatory assets under management (RAUM) in the United States. To qualify for the exemption, investment managers may not manage separate accounts; however, Asia-based fund managers may manage separate accounts so long as they are held by non-U.S. persons.

With respect to Asia-based investment advisers with no place of business in the United States, the SEC has noted that Section 203(a) of the Advisers Act provides that an adviser may not, unless registered, make use of any means or instrumentality of interstate commerce in connection with its business as an investment adviser. Hence, according to the SEC, whether an adviser with no place of business in the United States and no U.S. clients would be subject to registration depends on whether there is sufficient use of U.S. jurisdictional means (e.g., if, for instance, the fund managed by an Asia-based investment manager offered and/or sold shares to U.S. investors). Once jurisdictional means have been established, fund managers must then determine their RAUM for purposes of qualifying for the exemption. An adviser need count only private fund assets it manages at a place of business in the United States[9] in determining the $150 million RAUM limit. As a result, such adviser will be subject to SEC jurisdiction, but will not have to count any of its assets towards the $150 million RAUM limit. According to the SEC, the rule was designed so that a non-U.S. adviser may enter the U.S. market and take advantage of the exemption without regard to the type or number of its non-U.S. clients or the amount of assets it manages at a place of business outside of the United States. Although not required to register with the SEC, non-U.S. sponsors relying on this "private fund adviser exemption" will be an "exempt reporting adviser" required to file certain items of Part 1A of Form ADV, meet certain recordkeeping requirements and be subject to SEC examination, although the SEC indicated that it does not anticipate conducting regular compliance examinations of exempt reporting advisers.

The Dodd-Frank Act also amended the Advisers Act to create a foreign private adviser exemption. Under Section 202(a)(30) of the Advisers Act, a foreign private adviser is defined as an investment adviser that has no place of business in the United States; fewer than 15 clients and investors in the U.S. in private funds advised by the adviser; has RAUM of less than $25 million; does not hold itself out as an investment adviser to the public; and does not advise registered investment companies or business development companies. Rule 202(a)(30)-1 under the Advisers Act contains certain definitions and requirements for counting clients and investors. The manner in which advisers count clients and investors is similar to how such clients and investors are counted by private fund advisers when counting

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www.hflawreport.com Volume 5, Number 32 August 16, 2012

beneficial owners or qualified purchasers under Section 3(c)(1) or 3(c)(7), respectively, under the Investment Company Act. The limitations with regards to RAUM and the number of U.S. investors and U.S. clients make it unlikely that only but a handful of non-U.S. fund managers will utilize the foreign private adviser exemption. In certain circumstances, particularly where the Asia-based fund manager manages separate accounts for U.S. clients, the foreign private adviser exemption may be the only exemption available to the fund manager. For instance, if an Asia-based investment manager with no place of business in the United States manages $500 million in fund RAUM of which $20 million is attributable to 10 U.S. investors and $10 million in separately managed accounts, of which $4 million is attributable to 4 U.S. persons, the Asia-based fund manager would be exempt under the foreign private adviser exemption. See "Impact of the Foreign Private Adviser Exemption and the Private Fund Adviser Exemption on the U.S. Activities of Non-U.S. Hedge Fund Managers," The Hedge Fund Law Report, Vol. 4, No. 16 (May 13, 2011).

Commodity Pool Operator and Commodity Trading Advisor Regulation; New Reporting Obligations

A foreign domiciled fund with U.S. shareholders may be subject to the jurisdiction of the Commodity Futures Trading Commission (CFTC) if the offshore fund invests in CFTC regulated derivatives or "commodity interests." Commodity interests include listed futures, listed commodity options and those swaps regulated by the CFTC under the Dodd-Frank Act.[10] A hedge fund that trades these instruments will be deemed a "commodity pool" and its non-U.S. investment manager will be subject to regulation under the Commodity Exchange Act of 1974, as amended (CEA), and related regulations adopted by the CFTC, unless exempt from registration as a commodity pool operator (CPO). Historically, most Asia-based fund managers have relied on the exemption from CPO registration found in CFTC Rule 4.13(a)(4) which required investment managers to file a notice of exemption electronically with the National Futures Association (NFA) no later than the time it delivers a subscription agreement to a prospective pool participant, which is effective upon filing (Sophisticated Investor Exemption). In final rules recently adopted by the CFTC, the CFTC has rescinded the Sophisticated Investor Exemption, and CPOs that have previously claimed this exemption can only do so until December 31, 2012.[11] Thereafter, Asia-based fund managers will need to qualify for a new exemption or register as a CPO with the CFTC. The final rule, however, does retain CFTC Rule 4.13(a)(3), which provides a de minimis exemption from CPO registration for managers of funds that engage in limited trading of commodity interests; however, in light of the inclusion of swaps in the definition of commodity interests under the Dodd-Frank Act, it seems unlikely that many fund managers will be able to utilize this exemption.

The net result of the rescission of the Sophisticated Investor Exemption is that many fund managers that cannot utilize the de minimis exemption will be required to register as CPOs; however, many managers that register as a CPO may avail themselves of the limited exemption from certain CFTC requirements found in Rule 4.7. Managers exempt under Rule 4.7 will be limited to certain "substantive requirements" under Rule 4.7. The conditions to this exemption are as follows: (1) interests in the fund must be offered and sold to "qualified eligible persons" (which include qualified purchasers as well as certain non-U.S. persons); (2) the offering must be exempt from registration under the

Securities Act and (3) similar to the de minimis exemption, a fund manager claiming exemption under Rule 4.7 must make a notice filing with the NFA before any subscription is accepted into the fund. Any fund manager relying on the Rule 4.7 exemption will nevertheless be required to file new Form CPO-PQR. Depending on the amount of assets under management, Form CPO-PQR requires disclosure with respect to, among other things, the fund, key personnel, investment positions, creditors, counterparty exposure and borrowings. Violation of the CPO registration requirements could result in penalties such as suspension or expulsion from the NFA, a bar or suspension from associating with a NFA member and monetary fines. A private right of action may also be available in certain circumstances.

An Asia-based fund manager who provides trading advice regarding commodity interests will also need to register as a commodity trading advisor (CTA) unless an exemption is available. Investment managers previously relied on CFTC Rule 4.14(a)(8) for an exemption from CTA registration, which exempted advisers that provided advice to commodity pools whose CPO was exempt from registration under the Sophisticated Investor Exemption, the de minimis exemption and other exemptions. Asia-based fund managers may continue to utilize this exemption from CTA registration if they provide advice to CPOs who are exempt from registration under the de minimis exemption. Otherwise, the final rules retained other exemptions from CTA registration, and as a result, many Asia-based fund managers should be able to rely on two other exemptions from registration as a CTA. Section 4m(3) of the CEA exempts an investment adviser registered with the SEC whose business does not consist "primarily" of acting as a CTA, and the investment adviser does not act as a CTA to any commodity pool "engaged primarily" in trading commodity interests. In addition, an adviser that is not registered as an investment adviser under the Advisers Act may rely on a self-executing exemption under CFTC Rule 4.14(a)(10) if, during the course of the preceding 12 months, the adviser has not furnished commodity trading advice to more than 15 persons and it does not hold itself out to the public as a commodity trading adviser. There are specific provisions for counting (similar to the old investment adviser exemption rescinded by the Dodd-Frank Act) so that an entity, such as a commodity pool, would be deemed one person for purposes of the CTA exemption.

OFAC and Anti-Money Laundering

The Office of Foreign Assets Control (OFAC), a division of the U.S. Treasury, administers and enforces economic and trade sanctions that further U.S. foreign policy and national security goals against terrorists, targeted foreign countries, international drug traffickers and persons facilitating the proliferation of weapons of mass destruction. Many hedge funds include in their subscription agreements certain representations and warranties from investors that they fall outside the prohibited categories enumerated by OFAC. However, only U.S. persons, including investment advisers and their foreign offices and subsidiaries, must comply with OFAC's regulations. Although Asia-based fund managers are not technically required to include such representations or warranties in their subscription agreements, U.S. investors are required to comply. Also, U.S. institutional investors may demand a non-U.S. investment manager to require all its investors to comply with the OFAC regulations.

The HedgeFund LAW REPORT
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www.hflawreport.com Volume 5, Number 32 August 16, 2012

Privacy Rules

Finally, non-U.S. sponsors to hedge funds should be mindful of the requirements for the safeguarding of investor information included in the Gramm-Leach Bliley Financial Modernization Act of 1999 (GLB Act). The GLB Act requires federal regulators, including the SEC, the CFTC and the Federal Trade Commission (FTC), to adopt rules to govern the use of "consumers'" personal information by financial institutions under their respective jurisdictions. The FTC's privacy rules cover hedge fund managers who are neither registered investment advisers nor registered CPOs or CTAs as well as hedge funds that are exempt from registration as investment companies. Under the GLB Act, a manager or fund must notify "customers" of its or their policy regarding disclosure of nonpublic personal information; the manager or fund generally may not disclose nonpublic personal information to nonaffiliated third parties; and if the manager or fund chooses or reserves the right to disclose to unaffiliated third parties, the manager or fund must provide consumers with the opportunity to "opt out" from such disclosures. A U.S. investor who is an individual and purchases shares in an offshore fund would render the investor a customer of the fund and the Asia-based fund manager. Compliance with the GLB Act by hedge funds is relatively simple since funds generally do not disclose any information regarding their investors and merely will require the funds to provide initial and annual privacy notices to their investors. Fund managers also should be cognizant of applicable state privacy laws, including those regulations issued by the states, such as the State of Massachusetts, which is considered to have one of the most extensive privacy laws among the various U.S. states.

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The Hedge Fund Law Report
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www.hflawreport.com Volume 5, Number 32 August 16, 2012

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[1] Similar to exempted companies, each member of the Cayman unit trust has limited liability for the trust's obligations, and as a result the unit trust is treated as an association taxable as a corporation for U.S. federal income tax purposes under the default classification rules. An investment manager may file an affirmative election with the IRS to have a Cayman Islands unit trust classified as a partnership for U.S. federal income tax purposes. If the investment manager elects to treat the unit trust as a partnership, the manager must obtain a U.S. taxpayer identification number for the entity, and, once obtained, file Form 8832, Entity Classification Election, generally within 75 days of the day on which the entity wishes to change its default classification. If an entity wishes to retain its "default classification," no action need be taken by the investment manager.

[2] For U.S. federal income tax purposes, a resident alien includes an individual (i) present in the United States for 183 days or more (generally determined on a calendar-year basis) or (ii) who satisfies the "substantial presence test," by being present in the United States for at least 31 days in the current year and for a total of 183 days during the current year and the prior two years (as determined using applicable multipliers of 1/3 for the immediately preceding year and 1/6 for the second preceding year), or (iii) who otherwise has a "tax home" in the United States for federal income tax purposes.

[3] In some instances, however, after performing a careful tax analysis, a U.S. tax-exempt investor may be willing to invest in a U.S. partnership notwithstanding the likelihood that it will incur UBTI from such investment.

[4] It is important for these purposes that the corporate entity be organized in a low-tax jurisdiction, such as the Cayman Islands, in order to avoid a second layer of corporate taxation, which would be imposed upon a U.S. domestic corporation or a foreign domiciled corporation taxable as a corporation for U.S. federal income tax purposes.

[5] A U.S. tax exempt investor generally is unaffected by an offshore fund's status as a PFIC (unless it has acquired its PFIC investment with borrowings) since the rules were designed to combat deferral of income rather than to require income that was not otherwise taxable to then become subject to taxation.

[6] A Cayman Islands entity that elects to be classified as a partnership for U.S. federal income tax purposes will be required to file a U.S. federal partnership return and issue Schedules K-1 for each year in which it has one or more U.S. partners. A Form K-1 generally need not be issued to non-U.S. partners unless the master fund is considered to be engaged in a U.S. trade or business.

[7] Rule 502(c) states broadly that general solicitations may include, but are not limited to, "any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and any seminar or meeting whose attendees have been invited by any general solicitation or general advertising."

[8] The JOBS Act does not address how the rescission of the ban on general solicitation will impact the restriction on U.S. directed selling efforts under Regulation S.

[9] Rule 203(m)-1 defines a place of business as any office where the adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any other location that is held out to the general public as a location at which the investment adviser provides investment advisory services, solicits, meets with, or otherwise communicates with clients.

[10] The CFTC stated in the final rules rescinding the sophisticated investor exemption that it would not include swaps for purposes of calculating the trade limitation test under the de minimis exemption prior to the effective date of final rules promulgated by the CFTC further defining "swaps." On July 10, 2012, the CFTC voted 4 to 1 in favor of the final rule further defining "swaps," which means two months after the final rule is published in the Federal Register, fund managers will be required to include swaps in the calculation of notional value under the de minimis exemption.

[11] The Division of Swap Dealer and Intermediary Oversight of the CFTC (Division) issued a no-action letter dated July 10, 2012 providing limited temporary relief from registration as a CPO and CTA for those CPOs and CTAs that would have been exempt but for the recent rescission of Rule 4.13(a)(4). The no-action relief from registration for such CPOs or CTAs is extended until December 31, 2012, provided that such CPOs and CTAs file a notice with the Division claiming no-action relief, the notice is materially complete and the notice complies with the requirements of the no-action letter. The no-action relief is available for commodity pools launched after July 13, 2012; however, the no-action relief will not be applied retroactively for pools launched prior to July 13, 2012.