

# US Regulatory and Tax Considerations for Offshore Funds



Published in *The Capital Guide to Hedge Funds*, 2003



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## Chapter Twelve:

# US Regulatory and Tax Considerations for Offshore Funds

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Offshore funds<sup>1</sup> continue to provide an efficient, innovative means of facilitating cross-border professional management of investors' assets. This statement is still true, despite the events of the last year that have caused international financial transactions to come under increased scrutiny from onshore and offshore regulators and other law enforcement authorities. Offshore funds serve as delivery vehicles for international investment capital, still among the most nimble of economic factors, although a combination of laws relating to anti-money laundering and anti-terrorist financing (collectively, AML Laws) and a worldwide economic slowdown have tended to slow the growth and agility of such funds.

One of the characteristics of offshore funds that traditionally distinguished them from their onshore counterparts, the ability of investors to maintain confidentiality through relative anonymity, is giving way before national and international AML disclosure regimes, some adopted in haste, but all deriving from a grim impetus. It seems unlikely that removing such investor anonymity from the list of characteristics of offshore funds will spell their demise, any more than has the imposition of onshore national tax regimes designed to prevent tax deferral and evasion. Offshore funds will continue to exist because they serve an essential function as a financial crossroads where investment managers, investors and investment opportunities, none typically located in the offshore jurisdiction, can come together on neutral, tax-efficient grounds.

The imposition of various AML Laws, together with other regulatory schemes, many deriving from pre-9/11 origins, is a further indication that the term 'unregulated' is increasingly a misnomer as applied to offshore funds. National rules regulating the activities of offshore funds, especially in the AML area, continue to increase. While harmonisation in some aspects of AML regimes, as typified by the work of the Financial Action Task Force (FATF), has been welcome, such laws are only one part of a patchwork of laws and regulations, fiscal and other, that affect offshore funds. In many other areas, harmonisation among national regulators, or even among regulators in the same jurisdiction, has been lacking. The net effect continues to be that offshore funds, their managers and their professional advisers face increasingly varied regulatory and tax challenges.

The regulatory and tax regimes of the United States as they relate to offshore funds are no exception to this trend. When offshore funds come into contact with the United States,<sup>2</sup> they and their promoters encounter one of the most highly regulated investment management jurisdictions and complex tax codes in the world. They also encounter a jurisdiction whose regulators and tax authorities are not shy about extending the reach of US laws beyond national shores. Moreover, they do not encounter a single regulatory authority, but rather several regulators, each with its own functional area of responsibility and domestic constituencies. These regulators can and often do take disparate positions on similar questions; legal advisers to offshore funds may not assume uniformity of treatment among various regulators.

The regulatory and tax treatment that an offshore fund will encounter in the United States will depend upon the nature and extent of its contacts with the jurisdiction. These can include, moving from lesser-degree contacts to greater contacts:

- investments into the United States and custody of investment assets in the United States or by US persons;
- professional investment management by persons within the United States;
- promotion and/or sales of shares of the offshore fund<sup>3</sup> by persons within the United States to persons outside of the United States;
- US persons coming to own shares of the offshore fund by purchases on secondary securities markets; and
- sales of shares of the offshore fund within the United States.

Many of the lesser-degree contacts, including merely investing into the United States or maintaining custody of investment assets in the United States, may have US tax implications, but, with certain notable exceptions, generally will not trigger substantive regulatory concerns.<sup>4</sup> Almost

any greater contact will give rise to US regulatory and tax concerns. US tax laws can affect an offshore fund in a variety of ways: taxation of the fund's income derived from the US sources; taxation of the fund itself; taxation of US investors' realised income from the offshore fund; and even taxation of the US investor's proportionate share of the fund's income, whether or not distributed.

### Limited Contact with the United States — Investment and Custody

An offshore fund's contacts with the United States may be quite limited. Its investment management and administration, as well as its investors, may all be located outside of the United States. Its only US contacts may be investments in US securities and maintenance of custody of its assets with a US custodian. In such a case, assuming that the US securities purchased by the offshore fund are issued by entities treated as corporations for US tax purposes, the fund's US-source capital gains should not be subject to US taxation and the fund should not be required to file a US income tax return.<sup>5</sup> However, the gross amount of the offshore fund's US-source dividend and certain of its US-source interest income will be subject to US income (withholding) taxation. Furthermore, in these circumstances, most US regulatory burdens will not be severe and, in fact, may be no different than for any other investor or, in certain cases, any other foreign investor. However, even offshore funds with limited US contacts will find increased AML disclosure burdens as part of the price of dealing with US financial service providers, such as brokers and custodians.

### Reporting Obligations

Although a full discussion of the various reporting regimes to which a foreign person investing in the United States is subject is beyond the scope of this chapter, some of the more important reporting regimes for an offshore fund investing in US securities and commodities include the following:

- Section 13(d) of the Securities Exchange Act of 1934 (the Exchange Act)<sup>6</sup> requires persons (including groups of persons acting in concert, such as multiple funds managed by a single investment manager) whose acquisitions of shares of any US publicly-traded company cause their beneficial ownership to exceed 5% of any class of such company to report such acquisition to the company, the Securities and Exchange Commission (SEC) and the stock exchange on which the company's shares are traded, on Schedule 13D within 10 days after the acquisition. All material changes (defined to include 1% changes in ownership level) must be reported on an amended Schedule 13D. There are certain exemptions from the Schedule 13D filing requirements, but 5% beneficial

owners exempt from filing Schedule 13D are required to file Schedule 13G within 45 days after the end of the calendar year in which they exceed the 5% threshold (if they retain 5% beneficial ownership at the end of the calendar year). Schedules 13D and 13G are public records.

- Section 13(f) of the Exchange Act requires institutional investment managers that exercise investment discretion with respect to accounts holding equity securities of US publicly-traded companies<sup>7</sup> having a value in excess of US\$100 million to report such holdings on Form 13F to the SEC within 45 days after the last day of the first calendar year and each succeeding calendar year in which the US\$100 million is exceeded and within 45 days after the end of each calendar quarter in each such year. This reporting requirement would apply to the investment manager of an offshore fund investing in US publicly-traded securities. Form 13F is a public record, with certain exceptions.
- The Agricultural Foreign Investment Disclosure Act of 1978 (AFIDA)<sup>8</sup> requires foreign persons that own interests in US agricultural land to file reports with the US Department of Agriculture. This could, under certain circumstances, include reporting requirements for offshore funds that own 10% interests (either alone or in concert with other foreign persons) in US entities that hold US agricultural land or that hold any interest in such a US entity if foreign persons in the aggregate hold 50% or more of the US entity.
- Pursuant to Parts 15<sup>9</sup> and 18<sup>10</sup> of the Commodity Futures Trading Commission (CFTC) Regulations, an offshore fund or its investment manager can be required to file reports with the CFTC if its commodities positions exceed the reporting thresholds for particular futures contracts set forth in CFTC Regulation s. 15.03 and the offshore fund or its manager have received a special call for such reports from the CFTC. For the purposes of determining reporting thresholds, all accounts controlled by a reporting trader — eg, a common investment manager to a group of offshore funds — would be aggregated. If a special call for such reports has been issued by the CFTC, the trader is also required to file Form 40 with the CFTC, which discloses extensive information concerning the trader, its affiliates and its activities.<sup>11</sup> Every futures commission merchant or introducing broker that handles a futures transaction for a foreign person, such as an offshore fund, becomes the agent of the foreign person for the purposes of receiving communications from the CFTC, including the special

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call noted above, directed to the foreign person, unless the foreign person has designated another US person for such purpose.

### **Limitations on Investments in US Funds**

Section 12(d)(1) of the US Investment Company Act of 1940, as amended (the Investment Company Act)<sup>12</sup> imposes certain restrictions on the ability of certain investment companies to acquire shares of certain other investment companies. These restrictions effectively prohibit an offshore fund from purchasing more than 3% of the shares of an investment company registered under the Investment Company Act.

The s. 12(d)(1) restrictions apply only to 'investment companies' as defined generally in s. 3(a) of the Investment Company Act. Although virtually all offshore funds would fit within the general definition of 'investment company' in s. 3(a), s. 3(c) of the Investment Company Act contains numerous exclusions from the definition. Two of those exclusions, those contained in ss. 3(c)(1) and 3(c)(7), are commonly used by US and offshore 'private' investment funds to escape the requirement to register under the Investment Company Act.<sup>13</sup> Normally, offshore funds concern themselves with these exclusions only if they seek to offer their shares to US investors.<sup>14</sup> However, for the purposes of the s. 12(d)(1) restrictions, it should be noted that an offshore fund with no US investors should be able to 'qualify' for the s. 3(c)(1) exclusion, since it has fewer than 100 US investors, namely zero. Offshore funds that sell their shares to US investors will also effectively be required to qualify for one of the two exclusions — ie, either having fewer than 100 US beneficial shareholders (the s. 3(c)(1) exclusion) or having only US shareholders that are 'qualified purchasers' (the s. 3(c)(7) exclusion). Each of s. 3(c)(1) and s. 3(c)(7), while generally excluding a fund from the definition of 'investment company', also provides that the fund will nevertheless be considered an 'investment company' for the purposes of two narrow portions of s. 12(d)(1), ss. 12(d)(1)(A)(i) and 12(d)(1)(B)(i). Thus, the prohibitions of these two sub-sections would still apply to offshore funds.

Section 12(d)(1)(A)(i) prohibits an investment company, including, for this purpose, an offshore fund, and all companies controlled by it from *acquiring* in the aggregate more than 3% of the outstanding voting stock of an investment company registered under the Investment Company Act. Section 12(d)(1)(B)(i) mirrors s. 12(d)(1)(A)(i) in that it prohibits a US-registered investment company from *selling* more than 3% of its outstanding stock to any one investment company, including, for this purpose, an offshore fund and companies controlled by the investment company. The Investment Company Act contains a rebuttable presumption that 25% registered or beneficial ownership of shares of a company constitutes 'control'. In addition, the term 'investment company' can include various parties acting in concert.

### **Restrictions on Investments in 'Hot Issues'**

The 'Free-Riding and Withholding' interpretive rule<sup>15</sup> (the Interpretation) of the National Association of Securities Dealers, Inc. (NASD) imposes limits on the ability of an offshore fund to invest in initial public offerings sold by NASD members. Members of the selling group in a US public offering are required to dispose of their allocations to the public at the public offering price. It is not uncommon for secondary trading in such shares to commence before all members of the selling group have disposed of their allocations. When shares that are the subject of a public offering trade in the secondary market at a premium to the public offering price, they are termed 'hot issues'. Public offering rules preclude a selling group member from profiting by selling on the secondary market, but such selling group member might be tempted to allocate these valuable securities to persons who are in a position to favour the member by, eg, giving other brokerage business to the member or an affiliate. To combat this perceived abuse, the Interpretation prevents a NASD member from selling hot issues to certain restricted persons.<sup>16</sup> Generally speaking, these are individuals with senior positions in the securities industry or with institutional investors, but certain entities can also be restricted persons.<sup>17</sup> Restricted persons would include non-US individuals occupying similar positions with non-US securities companies or non-US institutional investors and analogous non-US entities.

The Interpretation specifically prohibits sales of hot issues to an investment fund<sup>18</sup> (generally including an offshore fund, but excluding a 'foreign investment company' as defined in the Interpretation (see below)) unless certain procedures are followed.<sup>19</sup> The NASD member may sell hot issues to investment funds that have provided to the member a list of the names and occupations of all investors in the fund so that the NASD member can make a determination that none of the investors is a restricted person. Alternatively, the NASD member may sell hot issues to a fund that makes such information available to its auditors or legal counsel, if such legal counsel or auditor, after following specified procedures, makes a reasonable determination that no person with an interest in the fund is a restricted person and so certifies to the NASD member. Either alternative means that a fund with a single restricted person as an investor cannot invest in hot issues. Such a fund may nevertheless invest in hot issues if it segregates its hot issue investments into a separate portfolio in which only non-restricted persons have an interest. This complicates accounting in the fund, but does allow participation in hot issues.

The prohibition on sales of hot issues to investment funds does not apply to sales to a 'foreign investment company'.<sup>20</sup> In order to be classified as a foreign investment company, a fund must be organised under the laws of a jurisdiction outside of the United States and must provide to the NASD member a certification by its legal counsel or an accountant

that: (i) the fund has 100 or more investors; (ii) the fund is listed on a foreign exchange or authorised for sale to the public by a foreign regulatory authority; (iii) no more than 5% of the fund's assets are to be invested in the hot issue; and (iv) no person owning more than 5% of the shares of the fund is a restricted person.<sup>21</sup>

### **Taxation of US-source Income**

One goal of the sponsors of an offshore fund is to avoid the fund's US-source capital gains being subject to US taxation. Generally speaking, individual foreign investors investing directly in US securities or commodities would not be subject to US taxation on their capital gains<sup>22</sup> and the objective of the fund's sponsors is to place the investors in no worse a tax position by investing through the fund than they would have encountered by investing directly.

Whether the offshore fund's US-source capital gains would be subject to US taxation depends upon whether the fund is considered to be engaged in trade or business in the United States. In the case of an offshore fund with limited contacts with the United States, ie:

- the fund's investment management and administrative activities are conducted outside of the United States;
- the fund's contacts with the United States are limited to investing in securities issued by US corporations<sup>23</sup> and in commodities, dealing through US securities and commodities brokers who act on an execution-only basis and without investment discretion, even if such securities and commodities are held in custody in the United States or by US persons; and
- the fund does not invest in US real property interests or in US corporations, a significant portion of whose assets consist of US real property interests,

it is unlikely that the fund would be considered to be engaged in a trade or business in the United States and, thus, its capital gains should not be taxed in the United States.

In the event that the fund would be considered to be engaged in a US trade or business, the fund would be required to: (i) file US and state income tax returns; and (ii) report as income for US federal and state income tax purposes the amount of gross income that is effectively connected with the conduct of such trade or business in the United States.<sup>24</sup>

In contrast to a fund that does not have income that is effectively connected to a US trade or business, a fund that has income that is effectively connected to such a trade or business could be subject to federal taxation on such income in excess of 50% if either the fund itself or, in the case of a fund that is in a partnership structure, the fund's partners were considered corporations for US income tax purposes.<sup>25</sup> In the case of an individual or trust that is a partner in a fund

that is in partnership form and has effectively connected income, the trust or individual could be subject to federal income taxation.<sup>26</sup> For these reasons, it is important that an offshore fund avoid having its income deemed effectively connected to a US trade or business.

### **Withholding Taxes**

If the offshore fund is not considered to be engaged in trade or business in the United States, then it will be subject to US withholding taxes on its US-source fixed, determinable, annual or periodic income. In the case of an offshore fund that invests principally in securities, this means that its US-source dividend and interest income will be subject to US withholding (income) tax. However, there are certain exceptions to this general rule of withholding for the offshore fund's US interest income. US withholding tax will not apply to US-source: (i) interest received as original issue discount on obligations payable within 183 days or less from the date of original issue; (ii) interest on certain deposits, including bank deposits described in s. 871(i)(2)(A) of the US Internal Revenue Code of 1986, as amended (the Code);<sup>27</sup> or (iii) interest on tax-exempt obligations as described in s. 103 of the Code.

In addition, US-source interest income of an offshore fund will be exempt from US withholding tax if it qualifies as 'portfolio interest' as defined by s. 871(h) of the Code.<sup>28</sup> However, if the offshore fund holds 10% or more of the equity interests in the US issuer of the debt, interest on the debt of the issuer held by the fund will not qualify as 'portfolio interest'.<sup>29</sup> While most offshore funds concentrate on portfolio investment in the United States and do not purchase as much as 10% of the equity interests in a single issuer, the latter situation can arise in the case of an offshore venture capital or private equity fund that purchases 10% or more of a US private issuer and at the same time extends bridge financing or mezzanine financing to the US issuer. In these circumstances, the portfolio interest exemption can be lost and the interest on the debt obligations would be subject to US withholding taxes.

Withholding tax on the offshore fund's US-source dividend income and its interest income that is not exempt for one of the reasons discussed above will generally be assessed at a 30% rate. However, that rate can be lower, depending upon: (i) whether the offshore fund is incorporated in a jurisdiction that has concluded a double taxation treaty with the United States that reduces the rate of withholding, and (ii) whether the fund is entitled to the benefits of such tax treaty. The United States has concluded double taxation treaties with many of the world's major capital-exporting nations, but has relatively few tax treaty connections with low- or no-tax offshore jurisdictions in which offshore funds are often organised.<sup>30</sup>

Most modern US double taxation treaties include provisions restricting their benefit to nationals of the foreign contracting



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state and entities owned by nationals of the foreign state. Thus, it is currently difficult to structure an offshore fund in a jurisdiction that gives tax treaty benefits, such as reduced US withholding taxes, if all or a significant portion of the shares in the offshore fund are owned by nationals of countries other than the jurisdiction in which the fund is organised.

Because of the 30% US withholding taxes on the dividend and certain interest income of most offshore funds, investors in such funds who are nationals of a country with which the United States has a double taxation treaty may find that investing through the offshore fund places them in a worse position, tax-wise, than if they had invested directly in the US securities, since in their individual capacities they could claim the benefits of their country's double taxation treaty with the United States. A possible escape from this dilemma exists if the offshore fund is structured as an entity that would be treated for US tax purposes as if it were a partnership. This would normally include limited partnerships and possibly also contractual forms of offshore funds, such as *fonds commun de placement*, as well as companies that have elected to be treated as partnerships for US tax purposes.<sup>31</sup> Such entities are viewed as 'tax transparent' and thus, depending upon the provisions of the tax treaty in question, investors in the fund may be able to claim a refund for their pro rata share of the fund's US- source dividend income from the US tax authorities for the difference between the 30% rate of withholding tax on, eg, dividends, and the rate to which they would be entitled under the double tax treaty between the United States and their home jurisdiction.

### FIRPTA

An important exception to the general rule that a foreign investor, including an offshore fund, will not be subject to US income taxation on capital gains from its US investments arises when the offshore fund invests in US real property interests (USRPIs). While typical offshore funds contain investment restrictions preventing the fund from investing in fee interests in real property, such restrictions often do not extend to corporations that purposefully invest in real property interests or that incidentally have significant real property assets. The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) taxes foreign investors on their gains from the disposition of direct USRPIs and on their gains from the disposition of interests in US corporations that qualify as 'United States real property holding corporations'.

Under FIRPTA, the net gain on dispositions of USRPIs received by a foreign person is deemed to be income effectively connected with the conduct of a US trade or business and is subject to US tax at normal rates and, in addition, to special withholding rules. Generally, a USRPI is any interest (other than a creditor's interest) in real property located in the 50 states of the United States or in the US Virgin Islands. In addition, a USRPI includes any interest in a US corporation unless it is established that the US

corporation has not been classified as a 'United States real property holding corporation' during the shorter of: (i) the period after 18 June 1980, during which the foreign person held the interest; and (ii) the five-year period ending on the date the interest is sold. A 'United States real property holding corporation' is defined as a corporation that owns USRPIs with fair market value of at least 50% of the fair market value of: (i) all of its real estate interests (US and foreign); and (ii) any other assets used or held for use in a trade or business. If, however, the shares of the US corporation holding the US real estate are publicly traded in the United States, and the foreign person (eg, the offshore fund) does not own (directly or indirectly) more than 5% of the class of shares of the US corporation, then the shares of the US corporation are not considered an interest in a United States real property holding corporation.<sup>32</sup>

### Sales Outside of the United States, Including Sales Activities Conducted from Within the United States and Internet Sales

Although sales of interests in offshore funds outside of the United States may not appear to constitute contacts with the United States giving rise to US regulatory concerns, offshore funds must nevertheless take care with their non-US sales<sup>33</sup> to ensure that they stay out of the US regulatory net. Regulation S<sup>34</sup> under the US Securities Act of 1933, as amended (the Securities Act)<sup>35</sup> and the SEC's interpretive release relating to Internet sales of securities provide guidance as to how offshore funds can avoid the US regulatory net when offering and selling their shares outside of the United States.<sup>36</sup> Sales activity from within the United States directed to persons outside of the United States can also be structured to avoid Securities Act registration requirements.

### Regulation S

Regulation S defines the circumstances in which a securities transaction, even one involving some use of the US interstate means of commerce, such as mail, telephone, etc, will be considered to be so removed from the United States and its regulatory concerns that it will not be subject to the registration requirements of the Securities Act. Regulation S provides the general rule that the registration and prospectus delivery requirements of the Securities Act will not apply to offers and sales of securities that occur outside of the United States. It supplements this general, and somewhat vague, rule with safe harbour rules<sup>37</sup> that provide comfort to offshore funds that their non-US sales will definitely not be subject to the registration requirements of the Securities Act if the conditions in the safe harbour rules are met.

The typical offshore fund will be considered, for the purposes of Regulation S, a 'foreign private issuer'.<sup>38</sup> In addition, the typical offshore fund will be considered not to have 'substantial US market interest'<sup>39</sup> in its securities.

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Accordingly, the typical offshore fund would be what is sometimes termed a 'Category I' issuer under the analysis of Regulation S. In order for sales by a Category I issuer (or a person acting on behalf of such an issuer) to qualify for the issuer safe harbour under Regulation S, the sole requirements are that the sale of shares of the fund be made in an 'offshore transaction' and that there be no 'directed selling efforts' in the United States made by the fund or by anyone acting on its behalf.

The requirement that a sale of shares be made in an offshore transaction is satisfied if no offer of the shares of the fund is made to a person in the United States and no purchase offer is accepted that is known by the fund or anyone acting on its behalf to have originated in the United States. In addition, certain sales of shares of an offshore fund to or through persons within the United States will be offshore transactions, thus coming within the Regulation S safe harbour. Sales pursuant to offers to a US professional fiduciary acting for the account of a non-US person, other than an estate or trust, will be considered an offshore transaction, as will offers and sales to certain international organisations and, significantly, their pension funds.

The other requirement for a Category I issuer, such as the typical offshore fund, to achieve the issuer safe harbour under Regulation S, is that neither the issuer nor any person acting on its behalf may have made any 'directed selling efforts' in the United States. Directed selling efforts are defined as any actions intended to, or which could reasonably be expected to result in, a conditioning of the US market for the securities in question — ie, actions that would encourage a flow-back of the securities to the United States. Such activities would include placing advertisements in publications having a general circulation in the United States.<sup>40</sup> The absence of such directed selling efforts will also be critical to ensuring regulatory compliance if the fund also makes a private placement of its shares in the United States.<sup>41</sup>

### **Sales from Within the United States**

The sponsors of an offshore fund sometimes retain the services of a US person to promote sales of fund shares to non-US investors. Such promotion is often undertaken by US brokerage firms and sometimes by US investment managers (often not the investment manager of the offshore fund) to provide investment alternatives for their non-US clientele.

Such promotional activities from within the United States would involve offers and sales of securities by US means of interstate commerce, eg, the mail and telephone, and, thus, could, in the absence of the comfort given by Regulation S, lead to the application of the registration provisions of the Securities Act.<sup>42</sup> However, such activities can often be structured to come within a Regulation S safe harbour.

In the case of promotional efforts for an offshore fund from an office within the United States, rules are normally imposed on those persons conducting the solicitation in order to ensure that the sales can be considered to have been made in offshore transactions. Those rules can be summarised as follows:

1. Orders may be solicited only from persons who are not US residents and who are not at that time physically located in the United States — ie, the solicitation must be by telephone or by mail. No offering materials may be delivered to any person in the United States.
2. No order may be accepted until the offering materials have been sent to the prospective investor at a location outside of the United States (preferably sent from an offshore location).
3. If a prospective investor receives offering materials at an address outside of the United States and later visits the United States, those responsible for promoting the fund from offices in the United States may not enter into any discussions concerning the fund that could be construed as a solicitation or offer.
4. Subscription applications known to be completed and/or signed in the United States must not be accepted.

As in the case of sales activities outside of the United States, in order to achieve the Regulation S safe harbour in the case of sales activities inside the United States, neither the issuer nor any person acting on its behalf may conduct directed selling efforts within the United States, as discussed above.

Such sales activities in respect of the fund's shares within the United States would be considered brokerage activity<sup>43</sup> within the United States, requiring the persons conducting such activities to be registered as brokers with the SEC and to become members of the National Association of Securities Dealers, Inc., the US self-regulatory organisation for securities brokers and dealers. This is primarily an issue for those persons conducting the sales activities, although it is possible that a transaction undertaken by an unregistered broker may be considered to have an illegal object and thus be voidable by the purchaser of the shares.<sup>44</sup>

In addition, such promotional activities from within the United States can raise issues under the Investment Company Act. As discussed more fully below, s. 7(d) of the Investment Company Act prohibits the use of the US interstate means of commerce in connection with a public offering of shares of an investment company, unless the investment company

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is registered under the Investment Company Act. The staff of the SEC have taken the position that such language refers to the use of the interstate means of commerce in connection with a public offering, regardless of whether the public offering is within or outside of the United States. However, the staff of the SEC have been willing to grant no-action relief where the public offering is conducted outside of the United States to non-US persons and the use of the interstate means of commerce is limited.

### **Documentation Suggestions**

The documentation by means of which the brokers or others are authorised by the fund to carry out sales activities, whether from within or outside of the United States, should specify that neither the issuer nor the broker, nor any person authorised by either, will sell shares other than in an offshore transaction or make any directed selling efforts in the United States in respect of the shares of the offshore fund. In addition, the documentation for sales by persons within the United States should incorporate special requirements as outlined above. In many instances, such brokers or others engaged in the sale of fund shares maintain custody of fund shares for their clients in their own name or in the name of an affiliated nominee company. In these instances, the sellers should also agree to undertake AML compliance, which the sponsors of the offshore fund can generally rely upon if the seller is a financial institution subject to the AML requirements of an FATF member country.

### **Anti-fraud Rules**

It should be noted that structuring a sale of shares of an offshore fund to be exempt from the registration requirements of the Securities Act, by structuring the transaction to either qualify for an exemption from registration or to be excluded from Securities Act coverage under Regulation S, does not mean that all aspects of US securities regulation have been avoided. For example, the use of any fraudulent statements in connection with a sale of securities is illegal and creates private rights of action under s. 10(b) of the Exchange Act and Rule 10b-5 thereunder. These rules can apply to offshore funds. Standards for disclosure under Rule 10b-5 are high, and liability may be assessed more stringently than in the case of common law fraud rights of action or other regulatory standards in effect in the home jurisdiction of the offshore fund. The circumstances in which a US court will conclude that jurisdiction lies for a plaintiff to assert liability under s. 10(b) and Rule 10b-5 relate to the question of the connection of the transaction to the United States. The greater the connection, the more likely that liability under s. 10(b) will attach to the transaction.

### **Internet Sales**

Offshore funds or their managers frequently place information concerning the fund on an Internet website. The website may simply have information about the fund and its

manager or may also include a web-based application form and procedure. Whether or not the website contains an application form, it would generally be considered an 'offer' for US securities law purposes.<sup>45</sup> The question arises as to whether such an offer is deemed to be made to persons within the United States, thus giving rise to the registration requirements of the Securities Act.<sup>46</sup>

The SEC has issued a release<sup>47</sup> (the Internet Release) giving guidance on the circumstances in which an advertisement of securities on an Internet website would be considered an offer of the securities in the United States. The Internet Release focuses particularly on information posted on the website and suggests that targeted Internet communications methods, such as mass e-mailings, would be evaluated under traditional principles applicable to solicitation by ordinary mail.

The basic message of the Internet Release is that if the offer of securities on the website is 'targeted to the United States', then the offer will be deemed made in the United States and will be subject to the registration and prospectus requirements of the Securities Act and the registration provisions of the Investment Company Act if the issuer is an investment company. The determination of whether the offer is so targeted will depend upon the facts and circumstances of each situation, but the SEC has offered important guidance on measures that can be taken by an issuer to avoid its Internet offer being considered to be targeted to the United States.

The SEC has stated in the Internet Release that Internet offers of securities by non-US issuers, such as offshore funds, would *not* be considered as targeted at the United States if the following steps are followed:

- The website should have a prominent disclaimer stating that the offer of securities is made only to persons in countries other than the United States. The SEC considers a generic statement to the effect that the offer is not made to any person in any jurisdiction in which it would not be legal to be inadequate. In addition, the disclaimer must be on the website page containing the offer of shares of the offshore fund or on a previous website page.
- The offshore fund operator must implement procedures reasonably designed to guard against sales to US persons in the offshore offering. This can be accomplished by requiring a potential purchaser's address or telephone numbers or area codes prior to selling securities or sending offering documentation. Other methods may also be used if they could reasonably be expected to be effective in preventing sales to US persons. Any indications from the content of the offshore fund's website that it is targeted to



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US persons, such as information concerning US taxation of income of the fund, will cause the offer to be considered to be made in the United States. Use of the English language, however, will not, in itself, indicate a targeting of the United States.

- Caution must be taken when placing information about the offshore fund's offering on a third-party's website, especially when the third-party's website specialises in investments available to or of special interest to US persons or is known to have a significant number of US clients or subscribers. Hyperlinks connecting the offshore fund's website to such third-party websites would also raise warning flags. In such circumstances, the offshore fund operator would be well-advised to require visitors to its website affirmatively to establish their non-US identity before allowing the visitor to proceed to its substantive pages.
- Any advertisements in US publications concerning the offshore fund operator should not contain mention of a website address containing offering materials for an offshore fund.

The SEC realises that it is possible that US persons may lie about their residences or use offshore nominees to evade the website operator's precautions and obtain shares of the offshore fund. The fact of such evasion will not cause the offshore fund's Internet offer to be considered targeted to the United States, as long as there are no overt indicators of US status, such as provision of US social security numbers or oral statements by the purchaser that he or she is a US person. The SEC also indicates that payments for shares drawn on US banks can be an indicator of US nationality of the purchaser, but this seems an ambiguous indicator in view of the many bona fide non-US investors that maintain dollar funds at a US bank account. The Internet Release implies that, consistent with previous SEC no-action letters, US persons who by stealth and deception evade the precautions taken by the offshore fund operator would not count towards the limited number (generally 100) of US investors that an offshore fund can have that seeks to take advantage of the s. 3(c)(1) exception from the definition of investment company in the Investment Company Act.<sup>48</sup>

Offshore funds sometimes seek to make a private placement of their securities in the United States concurrently with their international (ie, non-US) offering.<sup>49</sup> In those circumstances, the SEC is concerned that the posting of information concerning the international offering on the offshore fund operator's website might be used to generate interest in the exempt US offering, in contravention of the 'no general advertising or solicitation' requirement under Regulation D of the Securities Act. Because of this danger, the SEC suggests that additional precautions must be taken. One,

rather extreme, alternative suggested is to disqualify from participation in the US private placement any US person who visits the website, even if otherwise qualified as an investor in the US private placement. Exceptions could be made where it could be established that the US persons were solicited in the US private placement prior to visiting the website. This procedure obviously entails considerable record-keeping and is vulnerable to inadvertent failures. A more feasible further precaution, also endorsed by the SEC, is to require each visitor to the website to provide an address or a country/area code prior to being granted access to offering materials. Persons providing a US address or country/area code would be locked out from access to the offering materials. Care must be taken not to suggest methods of bypassing the screening mechanism. No information peculiar to the US exempt offering — eg, US tax disclosures for US purchasers or regulatory information of particular concern to US investors, such as ERISA disclosures — should be put on the website devoted to the international offering. The website could indicate that an offer of the offshore fund's shares cannot be made to US persons, except pursuant to an exemption from registration. However, no statements may be made as to the qualifications for US investors' eligibility for participation in an exempt offering. Further, no hyperlinks may be provided from the website to another website relating to the US offering, apparently even a password-protected website.

In terms of the manner in which an Internet website may be used to facilitate the sale of securities to US investors on a private placement basis, the staff of the SEC have issued their views in two no-action letters in *IPONET*<sup>50</sup> and *Lamp Technologies*.<sup>51</sup> Those letters involved the use of a third-party website maintained by an intermediary that were used to solicit information from potential investors to determine their qualification for the private placement of securities. Investors were given access to the password-protected portions of the website containing the information relating to the securities offerings only after they submitted questionnaires designed to elicit investor information and they were determined to be sophisticated and accredited investors. In both letters, the staff indicated that such posting of offering information in the restricted portions of the website, and providing access only to those investors determined to be qualified in the manner described in the letters, would not involve a public offering of securities.

In the context of first-party websites (ie, those that are maintained by the offeror of the securities or its investment adviser), although the SEC and its staff have yet to explicitly endorse the type of access restriction and accreditation process that was the subject of the two no-action letters, there is reason to believe that the SEC would not object to a similar arrangement in a website that is maintained by the offshore fund operator itself. In a footnote to the Internet Release, the SEC indicated that a foreign issuer that wished

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to use an Internet website to conduct the concurrent private placement in the United States could follow the general procedures developed in the domestic context for private placements on the Internet and cited the two no-action letters.<sup>52</sup> The release further indicated that if the 'offshore fund wishes to provide information on its website relating to its US private placement offer, it generally may do so without registering under the Investment Company Act if it adopts and implements password-type procedures with respect to that information' and again cited the *IPONET* and *Lamp Technologies* no-action letters. Note that in order to qualify for the exceptions under s. 3(c)(1) or s. 3(c)(7) of the Investment Company Act, the issuance of securities under either of those provisions requires, among others, that such issuance not involve a 'public offering' of securities. The SEC staff have indicated that the analysis with respect to public offering of securities for purposes of the 1940 Act is similar to the s. 4(2) private placement exemption under the Securities Act of 1933.

Internet offerings of securities may also have implications for the offshore fund's adviser under the US Advisers Act of 1940. If the adviser is operating under the *de minimis* exemption from registration (see Implications under the Investment Advisers Act – the offshore fund as client in the section of this chapter entitled *US Investment Manager*), certain information relating to the adviser that is posted on the website, even if incidental to the securities offering, may be deemed 'holding out' and could possibly jeopardise the use of the exception. Although SEC and staff guidance on this issue is relatively sparse, the Internet Release and SEC staff no-action letters<sup>53</sup> provide some broad guidelines. If the offshore fund's securities offering is intended to take place entirely outside the United States, to the extent that any information about the foreign adviser is even deemed to be 'holding out', measures reasonably designed to guard against an adviser holding itself out as an investment adviser in the United States, such as a prominent disclaimer making it clear to whom the site materials are (or are not) directed, should be implemented. In the context of an offshore fund that seeks to make a concurrent US private placement of the fund's securities, it would appear that the SEC's staff will not categorically conclude that the *de minimis* exception would not be available if some information about the adviser is disclosed on a website,<sup>54</sup> provided that such information is not solicitous in nature and is not readily accessible by the public at large (and, possibly, is not directed to persons expected to be consumers of investment management services).

### **New AML laws**

As noted in the introduction to this chapter, US and other AML Laws have been substantially expanded since the tragic events of 9/11. In October 2001, the United States enacted the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT) Act of 2001 (the PATRIOT Act).<sup>55</sup>

Title III of the PATRIOT Act amended the Bank Secrecy Act of 1970 (BSA)<sup>56</sup> to substantially expand and change the responsibilities of certain 'financial institutions' in respect of countering anti-money laundering and anti-terrorist (AML) activities.<sup>57</sup> Under the BSA, as amended, the term 'financial institution' includes investment companies, although the latter term was not defined in the BSA. Regulations adopted by the US Treasury in the spring of 2002 to implement these changes in the BSA<sup>58</sup> excluded from their coverage investment companies that are not registered under the Investment Company Act. In September 2002, the US Treasury proposed regulations<sup>59</sup> that would subject certain unregistered investment companies to the AML requirements of the BSA. These requirements of the proposed regulations would not apply to an offshore fund unless it sells shares to a US person<sup>60</sup> or is organised, operated or sponsored by a US person. Accordingly, an offshore fund with the type of limited contacts with the United States discussed in this section of the chapter would not be directly subject to the new AML requirements of the BSA under the proposed regulations.

However, among the financial institutions clearly subject to these expanded responsibilities are US brokers and custodians utilised by offshore funds for the purchase and safe-keeping of US securities. The BSA requires that such financial institutions, at a minimum, implement procedures for: (i) verifying the identity of any person seeking to open an account to the extent reasonable and practicable; (ii) maintaining records of the information used to verify a person's identity, including name, address and other identifying information; and (iii) consulting lists of known or suspected terrorists or terrorist organisations provided to the financial institution by any government agency to determine whether a person seeking to open an account appears on any such list.<sup>61</sup> In the case of an intermediary institution, such as an offshore fund, the US broker or custodian can be expected to make such enquiries in respect of the shareholders of the offshore fund, unless the fund or its administrator are subject to the AML requirements of a country that is a member country of the FATF and the fund and/or its administrator represents that they are in compliance with those requirements.

### **US Investment Manager**

An offshore fund has greater contact with the United States if it has a US investment manager or, if in partnership form, a US general partner, whether or not the US investment manager or general partner is the sponsor and organiser of the fund. This has potential US tax and regulatory implications for both the fund and its US investment manager or general partner.

### **Implications under the Advisers Act**

A US investment manager who has initially had success in managing the assets of US clients often seeks to manage sources of investment capital from outside of the United

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States. If the investments to be made by these non-US investors are not large enough to justify individual managed accounts, the US investment manager will often seek to pool the assets of such investors in an offshore fund. Assuming that the investment manager has been operating in the United States, it will already have considered whether to register as an investment adviser under the US Advisers Act of 1940, as amended (the Advisers Act).<sup>62</sup> However, compliance questions can arise for a US investment manager that are peculiar to offshore funds.

### The Offshore Fund as the Client

If the US investment manager is exempt from registration under the Advisers Act by reason of the *de minimis* rule,<sup>63</sup> it may be concerned about the question of how many clients the offshore fund constitutes for the purposes of the Advisers Act. The rules for determining who is the client of the US investment manager and how many clients are constituted by the offshore fund for the purposes of the Advisers Act are generally the same as would apply to US investment funds. An offshore fund in corporate form, rather than its shareholders, should be considered to be the client of the investment manager. Note, however, that in the case of an offshore series fund in corporate form, the best practice would be to consider each series within the fund to be a separate client. In the case of an offshore fund organised in partnership form, often the US investment manager or its affiliate serves as general partner of the partnership. The partnership, rather than the individual partners in the offshore fund, will be considered the client of the US general partner/investment manager provided that (i) the assets of the offshore partnership are invested as a single pool (ie, the partnership is not structured with multiple portfolios, each corresponding to a partner in the offshore fund); (ii) the investment manager does not advise the individual limited partners on purchasing the partnership interest;<sup>64</sup> (iii) the interests in the offshore fund are securities (this will normally be the case); and (iv) no investor in the offshore partnership is separately a client of the investment manager or general partner or any of their affiliates.<sup>65</sup>

### Performance Fees

In most respects, a US-based investment adviser that is registered under the Advisers Act must treat a non-US client in accordance with the same rules that it follows for US clients.<sup>66</sup> Until the National Securities Markets Improvement Act of 1996 (NSMIA),<sup>67</sup> this rule applied to all important aspects of regulation of US-registered investment advisers, including the general prohibition on performance fees.<sup>68</sup> US investment advisers complained that their inability to charge performance fees (regardless of the exceptions available) placed them at a competitive disadvantage vis-à-vis non-US-based investment advisers (registered under the Advisers Act or not)<sup>69</sup> in soliciting and structuring contractual arrangements with non-US clients.

In response, the US Congress, in NSMIA, added s. 205(b)(5) of the Advisers Act, which provides that the performance fee prohibition of s. 205 will not apply to contracts entered into with non-residents of the United States. The question for a US investment manager of an offshore fund thus becomes whether the offshore fund constitutes a non-resident of the United States, so that the investment adviser need not obey the prohibition on performance fees nor comply with the recognised exceptions to the prohibition. Neither the text of NSMIA nor the legislative history give any definition of non-resident of the United States. Clearly, an offshore fund that is incorporated in a jurisdiction outside of the United States and that has no US shareholders would be considered a non-resident. However, some offshore funds whose assets are managed by US-resident advisers may have some US-resident shareholders.<sup>70</sup> The question arises as to whether the presence of such US-resident shareholders affects the ability of the investment adviser to rely on s. 205(b)(5) of the Advisers Act, especially in light of the *Rosenberg Institutional Equity Management* no-action letter<sup>71</sup> that granted similar relief, but only in the context of a fund with no US shareholders. In the absence of any guidance in the statute or legislative history or contrary indication from the staff of the SEC, it would seem safe to rely on s. 205(b)(5) in the case of an offshore fund in which US shareholding is incidental. Despite its technical applicability, it would not be prudent to rely on that section in the case of a fund in which there is predominant US shareholding, as the SEC may take the position that the offshore incorporation of the fund is merely part of a scheme to evade the prohibitions of s. 205 of the Advisers Act.<sup>72</sup> If US shareholding in the fund is significant and the performance fee arrangement would otherwise conform to Rule 205-3, the US investment adviser would be prudent to require all US investors in the fund to represent that they have the characteristics necessary to constitute them as proper clients for a performance fee (ie, a commitment of at least US\$750,000 to the fund or a net worth of at least US\$1.5 million).

### Record-keeping

The general record-keeping requirements of the Advisers Act would apply to the transactions in the account of the offshore fund with the investment manager, but these record-keeping rules would not require the investment manager to maintain corporate or partnership records of the fund itself.

### Brochure Rule

Rule 204-3 under the Advisers Act, commonly known as the 'Brochure Rule', requires a registered adviser to deliver certain information to its clients initially, and thereafter on a periodic basis. The investment manager should be able to treat the offshore fund as the client to whom the required brochure<sup>73</sup> is to be delivered. However, many registered US investment advisers who manage the investments of offshore funds make it a practice to deliver the brochure (the information in Part II of the adviser's registration form, Form

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ADV) with the offering materials for the fund, or at least to make it available for inspection together with other material documents relating to the fund.

### Client Solicitation Rule

The SEC rule that regulates cash payments by registered investment advisers to third parties for client solicitations<sup>74</sup> (the Solicitation Rule) may be controversial in its application to offshore funds. The rule generally requires that a registered investment adviser may pay a cash fee to a third party for soliciting a client for the investment adviser only if: (i) the solicitor has not been subject to certain disciplinary measures or convicted of certain crimes; and (ii) the fee is paid pursuant to a written agreement that requires the solicitor to disclose to the potential client certain matters, including the fact that the solicitor is being paid by the investment adviser for its solicitation activities and the amount of the compensation. The purpose of the rule is to make clear to the potential client that he or she is not receiving disinterested advice from the solicitor.

This can be a particularly sensitive issue as relates to solicitation of investors for an offshore fund. Arrangements for compensation of such solicitors is an important part of the fund-raising activities for offshore funds, and outside of the United States it would be uncommon to require the solicitors to make the types of disclosures to the potential investors that would be required by the Solicitation Rule. Note that if the compensation to the solicitor were paid by the offshore fund itself and not, directly or indirectly, by the adviser, then the rule would not apply.

Often an investment manager/sponsor of an offshore fund will pay to persons responsible for solicitation of investors in the fund a portion of the fees payable by the fund to the investment manager. The question then arises as to whether the Solicitation Rule applies to the practice. On the basis that the fund itself, and not the investors in the fund, is the client of the investment adviser, some advisers do not require compliance with the Solicitation Rule by persons that solicit investors for the fund since they are not, in this technical sense, soliciting clients for the adviser. This position is particularly defensible where the offshore fund is in corporate form and has independent directors. Legal counsel for other advisers consider that solicitation for investors in the fund is tantamount to solicitation of clients for the investment adviser.<sup>75</sup> This conclusion is particularly applicable where the offshore fund is in partnership form and the investment adviser or a controlled affiliate is the general partner.

### **Implications under the Commodity Exchange Act**

If the offshore fund invests in financial instruments that fall within the definition of a 'commodity futures contract' in the Commodity Exchange Act (CEA),<sup>76</sup> then the fund may fall within the definition of a 'commodity pool' under the

CEA. It should be noted that commodities futures contracts include financial instruments such as stock exchange index futures and other instruments that are commonly used to hedge investment risk in portfolios consisting principally of securities. This would include foreign (ie, non-US) futures and options contracts.<sup>77</sup> If the investment manager or others responsible for the operation of the fund are within the United States,<sup>78</sup> then the investment manager and such persons must consider the implications of the CEA and the regulations adopted thereunder by the CFTC. Generally speaking, even if the fund has no US investors, if those persons (directors or administrators) responsible for the operations of an offshore fund that is a commodity pool are within the United States, they would be subject to registration as commodity pool operators (CPOs) and be required to become members of the National Futures Association (NFA), a self-regulatory organisation for commodity industry participants.

The US investment manager of an offshore fund that is a commodity pool would likely be required to register with the CFTC as a commodity trading adviser (CTA) and become a member of the NFA. It is likely that the US investment manager will have already faced this problem in respect of its domestic individual or fund clients. However, if the US investment manager has only individual US clients and has been operating on the CFTC's *de minimis* rule,<sup>79</sup> it should note the CFTC's position that for the purposes of counting clients of a US CTA, one 'looks through' a fund to count investors in the fund as clients of the CTA.<sup>80</sup>

If the operator of a pool is registered with the CFTC as a CPO, it is subject to certain reporting requirements to investors in the pool,<sup>81</sup> disclosure requirements to investors and potential investors in the pool,<sup>82</sup> and record-keeping requirements.<sup>83</sup> These requirements have been modified for registered CPOs as they relate to certain offshore commodity pools. CFTC Advisory Opinion 18-96 provides relief in the case of a commodity pool that is organised outside of the United States, has no investor that is a US person, does not receive, hold or invest any capital contributed from sources within the United States, and does not undertake any marketing activity that could reasonably have the effect of soliciting investments from US persons. The operator of such a pool may file a claim with the CFTC and the NFA for relief from many of the normal record-keeping, reporting and disclosure requirements otherwise imposed on CPOs.

### **Additional AML Requirements**

As discussed above, the expanded AML requirements under the BSA as amended by the PATRIOT Act do not apply to an offshore fund unless it sells its shares to a US person or is organised, operated or sponsored by a US person. There is no discussion in the proposed Treasury regulations of what constitutes organising, operating or sponsoring an offshore fund. For example, it is unclear whether an offshore multi-manager fund sponsored by an entity outside of the



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United States that simply hires a US money manager to manage a portion of its assets would fall under the new AML requirements — ie, does the US money manager ‘operate’ the fund under these circumstances?<sup>84</sup> Assuming that the role of the US investment manager would constitute organising, operating or sponsoring the fund, then the new AML laws will apply directly to the fund if it meets certain other criteria. Those other criteria are: (i) that the fund allows investors to redeem all or any portion of their interest in the fund within two years after they acquired it; and (ii) that the fund has total assets of US\$1 million or more as at the end of the most recently completed calendar quarter.

A more complete discussion of the requirements of the new AML requirements for a covered offshore fund is contained in Chapter Ten of this book but, in general, the offshore fund would be required to:

- establish and implement policies, procedures and internal controls reasonably designed to prevent the offshore fund from being used to launder money or finance terrorist activities, including — but not limited to — achieving compliance with the applicable portions of the BSA and the regulations thereunder;
- provide for independent testing for compliance to be conducted by company personnel or by a qualified outside party;
- designate a person or persons responsible for implementing and monitoring the operations and internal controls of the programme; and
- provide ongoing training for appropriate persons administering the programme.

In addition, under the proposed regulations, each covered unregistered investment company, including offshore funds in the circumstances noted above, would be required to file a notice with the US Treasury identifying itself as an unregistered investment company subject to the regulations and stating names and contact information of the fund, its organiser, sponsor and investment managers and its AML compliance officer, the dollar amount of assets in the fund and the number of shareholders of the fund.<sup>85</sup>

Section 326 of the BSA, as amended by the PATRIOT Act, also requires covered financial institutions to implement client identification and verification procedures.<sup>86</sup> Regulations implementing these requirements for unregistered investment companies, including offshore funds, have not yet been adopted.

### ***Tax Implications to the Offshore Fund of Having a US Investment Manager/Sponsor***

A foreign entity, such as an offshore fund, might be considered engaged in trade or business in the United States if it conducts its activities from offices within the United States. If the fund is engaged in a trade or business from an office

of the fund within the United States, its net income that is effectively connected with that trade or business, including any capital gains on securities realised in connection with the conduct of that trade or business, will be taxable at normal US tax rates by the United States and by the states of the United States in which the trade or business is considered to be conducted. If the offshore fund is structured as an entity recognised for US tax purposes as a corporation rather than a partnership,<sup>87</sup> then the taxpayer, for US federal and state tax purposes, would be the offshore fund entity itself and the offshore fund would be required to file a federal and state income tax return and pay the applicable taxes on its net income effectively connected with its US trade or business at the applicable rates for taxation of corporate income,<sup>88</sup> plus, at the federal level, branch profits tax on ‘deemed dividends’ attributable to the branch. The branch profits tax of 30%, may be reduced by applicable treaties.<sup>89</sup>

If the offshore fund is structured as an entity recognised as a partnership for US tax purposes, each of the partners of the partnership (normally the foreign investors in the offshore fund) would be considered to be engaged in a trade or business in the United States on the basis of principles of US taxation that consider the partners of a partnership to be engaged in trade or business wherever the partnership is so engaged. The result in this case would be that each of the foreign investors in the offshore fund would become a US federal and state taxpayer in respect of its allocable portion of the income effectively connected with the trade or business conducted by the offshore fund and would be required to file US federal and state tax returns.<sup>90</sup>

In view of the goal of the sponsor of the offshore fund mentioned above, namely to avoid putting the offshore investor into a worse US tax position by investing through the offshore fund than if the investor had directly purchased the fund’s investments, it becomes critical that the offshore fund avoid being considered to be engaged in a US trade or business.<sup>91</sup> An offshore fund sponsored by a US money manager would typically involve either: (i) an investment management agreement between the US money manager and an offshore fund in corporate form; or (ii) the US money manager serving as a general partner of an offshore fund in partnership form. In either case, the offshore fund may be considered to have an office within the United States at the office of the US money manager. If so, the question becomes whether the offshore fund is itself engaged in an identifiable trade or business, or merely acts as a passive investor engaged in no identifiable trade or business. Most US tax counsel for offshore funds have been reluctant to rely on the position that the offshore fund is not engaged in some type of trade or business merely by reason of its passive nature.

Traditionally, offshore funds have sought the protection of a ‘safe harbour’ provision of the Code that provides comfort that certain types of activities do not constitute the conduct of

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a trade or business in the United States. Code s. 864(b)(2) provides that a corporation, including a foreign corporation such as an offshore fund in corporate form<sup>92</sup> (other than a dealer in stocks or securities), that trades in stocks or securities for its own account, whether through a US-resident broker, commission agent, custodian or other agent (such as an investment manager), whether or not such agent has discretionary authority to make decisions in effecting such transactions, will not, solely by reason of such activities, be considered to be engaged in a trade or business in the United States.

Until the Taxpayer Relief Act of 1997 (TRA),<sup>93</sup> there was an additional requirement that the corporation should not have its principal office in the United States. Regulations adopted by the Internal Revenue Service (IRS) under s. 864(b)(2) provided that a foreign corporation would not be considered to have its principal office in the United States if 'substantially all' of ten functions (which came to be known as the Ten Commandments) were performed from an office of the corporation outside of the United States.<sup>94</sup> The Ten Commandments requirements, together with other factors, led to the creation of extensive fund administrative businesses outside of the United States, typically in the domicile of the offshore funds.

The TRA amended s. 864(b)(2) to remove the requirement that the offshore fund's principal office be located outside of the United States in order to secure the safe harbour benefits of s. 864. This means that the administrative tasks represented by the Ten Commandments could, from a US federal income tax point of view, be performed in the United States, even by the investment manager that sponsored the fund and who manages its investments. Many commentators predicted that the changes to s. 864 wrought by the TRA would lead to the substantial migration of the administrative functions for offshore funds sponsored by US investment managers from the tax havens to the United States. Several factors have, however, impeded or delayed the process.

First is inertia. Many US investment managers whose funds are competently and efficiently managed from offshore locations may find it easiest, especially with respect to existing funds, to leave the management offshore.

Second, many smaller US investment managers may lack the capacity to perform the administrative functions, especially the book-keeping, net asset value calculation and shareholder servicing functions, themselves. Many offshore funds may not provide the volume of investment activity or number of shareholders that would make third-party administrative service firms in the United States cost-effective.

Third, offshore funds that are sold to individual investors may choose to retain at least certain aspects of offshore

administration, such as registrar and transfer agency and shareholder communications. This is because many individual investors believe that the confidentiality that offshore funds have traditionally offered will be compromised by onshore administration, either because of relatively weaker confidentiality laws or relatively more aggressive securities regulators and tax authorities. Some individual investors may be concerned about Memoranda of Understanding,<sup>95</sup> Information Sharing Agreements and other agreements regarding co-operation and information sharing between US regulators and tax authorities and their counterparts in the home countries of the investors. The disclosure requirements of US AML laws may have the effect of reducing any perceived advantage that offshore administration has for investor confidentiality, unless AML compliance is undertaken principally by the offshore administrator.

Finally, it must be recalled that each of the states of the United States also imposes taxation of entities, including foreign entities, that are considered to be doing business within their jurisdictions. Although most states followed the federal lead with the pre-TRA s. 864 rules, not all states have updated their laws to reflect the changes made in the TRA. The states in which the investment managers of most offshore funds are located, such as New York, California and Massachusetts, have generally followed the TRA amendments to § 864. However, if a fund has a US investment manager in a state that has not revised its law to reflect the TRA, and the Ten Commandments functions are performed in that state, the state may take the position that the offshore fund is doing business within the state, thus giving the state the jurisdiction to tax the income, including capital gains, of the fund.

### US Shareholders Other Than from Offerings in the United States

An offshore fund may seek to limit its contacts with the United States for a variety of reasons. It may choose not to sell its shares in the United States, not to issue its shares to US persons, and even to prevent transfers of shares to US persons by restricting the ability to reregister shares in the name of a US person. However, if the shares of the fund are listed and actively traded on a secondary market outside of the United States, such as a stock exchange, or if the shares are held by individuals, the ability of the fund to prevent its shares from becoming beneficially held by US persons is limited. US persons may seek to purchase shares of the fund on the secondary market through local market intermediaries and may hold such shares in the nominee name of a local custodian or broker, so that it is difficult for the management of the offshore fund to know of or prevent US beneficial ownership. Also, individuals can change residence. The investor who was resident outside of the United States at the time of the investment can later become resident in the United States.<sup>96</sup>

### **Investment Company Act Issues**

Offshore funds must be concerned with the number of US persons that hold their shares because of certain interpretations of the Investment Company Act made in 1984 by the staff of the SEC in the *Touche Remnant* no-action letter.<sup>97</sup> In order to understand the interpretation, a brief review of the Investment Company Act's differential treatment of investment companies organised within and outside of the United States is necessary.

Section 7 of the Investment Company Act, by prohibiting certain transactions by unregistered investment companies, defines those circumstances in which an entity meeting the definition of 'investment company' under the Investment Company Act must register with the SEC under the terms of the Investment Company Act. Such registration is a time-consuming and costly affair, normally undertaken only by funds intended to be offered to the public in the United States. In addition, registration under the Investment Company Act subjects the fund to the extensive, substantive regulatory requirements of the Investment Company Act. Sections 7(a)–(c) of the Investment Company Act set forth prohibitions on the activities of investment companies organised under the laws of the United States. Any such entity meeting the definition of investment company<sup>98</sup> and seeking to use the US interstate means of commerce in the conduct of its business as an investment company must register.

Section 7(d) of the Investment Company Act generally prohibits an investment company organised *outside* of the United States from making a public offering of its securities in the United States. However, a non-US investment company is allowed to register under the Investment Company Act and make a public offering of its securities if it obtains an order from the SEC finding that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of the Investment Company Act against the non-US investment company and that the issuance of the SEC's order allowing registration is otherwise consistent with the public interest and the protection of investors. Currently, obtaining such an order from the SEC allowing the registration of a non-US investment company under the Investment Company Act is a practical impossibility.<sup>99</sup> However, under the strict terms of the Investment Company Act, an investment company organised under the laws of a jurisdiction outside of the United States could have an unlimited number of US shareholders and could even offer its shares in the United States to US persons, as long as it did not make a public offering of its shares in the United States.<sup>100</sup>

Entities (US or foreign) that otherwise meet the general definition of 'investment company' under the Investment Company Act are, nevertheless, excluded from the definition if they have not made, and do not propose to make, a public offering of their securities, and their securities (other

than short-term paper) are held by not more than 100 persons. Since an investment fund organised under the laws of the United States is effectively required to register if it has more than 100 shareholders or, if it has more than 100 shareholders, not all such shareholders are qualified purchasers<sup>101</sup> (whether by private placement or otherwise), a US fund could be seen to be at a competitive disadvantage to an offshore fund which, under the strict terms of s. 7(d) of the Investment Company Act, is required to register only if it makes a public offering in the United States, regardless of the number of its shareholders, US or foreign.

This perceived inequality of treatment (and the perceived gap in the SEC's ability to regulate foreign funds making private offerings to US persons) prompted the staff of the SEC to address the issue in the *Touche Remnant* no-action letter. The staff of the SEC in that no-action letter took the position that the intent of the US Congress in adopting s. 7(d) of the Investment Company Act was to regulate the activities of non-US investment companies whenever they came to have a significant impact on the United States. Although the statute seems to have a clear defining threshold for such significant impact (a public offering of the foreign fund's shares), the staff of the SEC were reluctant to accept that threshold for the reasons noted above. Seeking to place US and foreign funds on the same footing, the staff seized upon the '100 shareholder' standard of s. 3(c)(1) of the Investment Company Act and stated that if an offshore fund making a private offering in the United States came to have more than 100 US shareholders,<sup>102</sup> it would have the type of significant impact on US markets that, in the view of the staff of the SEC, would require the foreign fund to register under the Investment Company Act.<sup>103</sup> Since registration of a foreign investment fund is currently a practical impossibility, offshore funds that make a private offering of their shares in the United States are careful to conduct the offering so as to result in the offshore fund having fewer than 100 US shareholders or having only US shareholders that are 'qualified purchasers'.<sup>104</sup>

US legal counsel to offshore funds generally felt that a non-US fund that had never consciously offered its shares in the United States or to US persons would not have to register under the Investment Company Act, even under the *Touche Remnant* interpretation, if the fund came to have more than 100 US shareholders by reason of secondary purchases of shares by US persons or by non-US shareholders later becoming resident in the United States.<sup>105</sup> However, there was a concern that a fund that had made a private offering in the United States to fewer than 100 US persons and later came to have more than 100 persons through secondary purchases or shareholder relocations would be subject to registration under the *Touche Remnant* doctrine. This issue was clarified in the no-action letter granted to the Investment Funds Institute of Canada (IFIC).<sup>106</sup> That no-action letter indicated that a non-US fund, even one that had made a

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private offering in the United States, would be able to count as non-US holders (ie, not count towards the 100 maximum US shareholders) those US persons who obtain the shares or become US shareholders without volitional action by the offshore fund. Thus, the offshore fund would not have to count US persons that purchased shares on a secondary securities market or relocated to the United States, provided that certain conditions are met. Those conditions are intended to ensure that the fund has not taken actions to encourage or facilitate secondary market purchases of the fund's shares by US persons.<sup>107</sup>

Most offshore funds have provisions in their articles or other constitutive documents that allow the funds compulsorily to redeem US persons that become shareholders. Although such provisions are likely included to prevent Investment Company Act problems, their implementation is often not conditioned on the shareholder in question actually causing an Investment Company Act problem. It becomes a question of interpretation under the laws of the fund's domicile as to whether such compulsory redemption provisions can in good faith be used by the fund to redeem US persons that have purchased shares in the secondary market and thus do not count as US beneficial owners for Investment Company Act purposes.

### **Tender Offer Rules**

Whether an offshore fund obtains US shareholders inadvertently through secondary market purchases or deliberately through sales of shares to US persons as described in the following section, there may be instances in which it seeks to repurchase its own shares from such persons. Offshore closed-ended funds will often implement such self-tenders in an effort to reduce the discount to net asset value at which shares of such funds trade on stock exchanges. Offshore funds may also seek to take over or combine with other offshore funds by making an offer to purchase shares of the other offshore funds. In either case, the question arises as to whether US shareholders may participate in the offer. Where such offers are exchange offers — ie, involve the offer of a newly-issued security in exchange for the shares sought — they will be treated as a sale of the newly-issued security that must be registered under the Securities Act or exempt from registration as discussed in the section entitled *Non-public Offerings of Shares of an Offshore Fund in the United States*, below.<sup>108</sup> Where such offers are for cash consideration, Securities Act issues normally will not exist, but offering funds and, to some extent, offeree funds must comply with certain portions of the US tender offer rules if they include US shareholders in the tender offer.

Various portions of the Exchange Act and regulations adopted by the SEC thereunder are applicable to tender offers made in the United States. However, the most rigorous of those rules apply only to shares of US public companies

registered under s. 12 of the Exchange Act. Since shares of an offshore fund would not be registered under s. 12 of the Exchange Act, a tender offer for its shares would not be subject to many of the US tender offer rules. In addition, recent changes to US tender offer rules relating to cross-border tenders can give certain additional relief for tenders for shares of offshore funds.

Section 14(e) of the Exchange Act applies to all tender offers, including those for shares of offshore funds. It provides that it shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive or manipulative acts or practices in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to, or in favour of, any such offer, request or invitation. In the case of a tender offer for shares of an offshore fund, all statements made in the circular or other tender offer materials should be evaluated in light of this standard if the offer is extended to shareholders of the fund resident in the United States.

Section 14(e) of the Exchange Act also gives the SEC the authority, by rules and regulations, to define and prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive or manipulative. Pursuant to this authority, the SEC has promulgated Regulation 14E of the Exchange Act. Regulation 14E applies to all tender offers, unless otherwise stated.

Rule 14e-1 pertains to unlawful tender offer practices. The rule is meant to prevent fraudulent practices within the meaning of s. 14(e) of the 1934 Act.

- Rule 14e-1(a) prohibits any person who makes a tender offer from holding such tender offer open for less than 20 business days<sup>109</sup> from the date the tender offer is first published or sent to security holders.
- Rule 14e-1(b) prohibits any person who makes a tender offer from increasing or decreasing the percentage of the class of securities being sought or the consideration offered or the dealer's soliciting fee being given in a tender offer unless such tender offer remains open for at least 10 business days from the date that notice of such increase or decrease is first published or sent or given to the security holders.<sup>110</sup>
- Rule 14e-1(c) states that any person making a tender offer may not fail to pay the offered consideration, or fail to return the securities deposited by or on behalf of the security holders, promptly after the termination or withdrawal of a tender offer.



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- Rule 14e-1(d) prohibits any person making a tender offer from extending the length of the tender offer without issuing a notice of such extension by press release or other public announcement. The notice must include disclosure of the approximate number of securities deposited to date.
- Rule 14e-2 pertains to the position of the target company with respect to the tender offer. This rule provides that the target company, no later than 10 business days from the date the tender offer is first published or sent to security holders, must publish, send or give to security holders a statement disclosing that the board of the target company: (i) recommends the acceptance or rejection of the tender offer; (ii) expresses no opinion and is remaining neutral towards the tender offer; or (iii) is unable to take a position with respect to the tender offer with specific reasoning. Once disclosure of the preceding has been made, any material changes in such information must be immediately published, given or sent to the security holders by the subject company.

Rule 14e-3 embodies an insider trading prohibition. It provides that it is a fraudulent, deceptive or manipulative act for any person who is in possession of material information relating to a tender offer made, or about to be made, to purchase, sell, or cause to be purchased or sold, any of the securities or securities convertible or exchangeable for the securities sought in the tender offer, unless within a reasonable time prior to the purchase or sale of such securities, the information and its source are publicly disclosed by press release or otherwise, if the person knows that such information is non-public and has been obtained from the tender offeror, the issuer of the securities being sought or an officer, director, partner, employee or other person acting on behalf of the tender offer or the issuer. Rule 14e-3 also prohibits persons connected with the offeror or the issuer from communicating to third parties material, non-public information if it is reasonably foreseeable that the communication of such information will violate the provisions of the rule. However, it is not a violation of this provision if an entity, other than a natural person, demonstrates that the individual(s) making the investment decision on behalf of the entity was not aware of the material, non-public information and such entity has implemented reasonable policies and procedures to ensure that individual(s) making the investment decisions on behalf of the entity will not violate the provisions of Rule 14e-3. There are also exceptions within the rule which are geared towards the purchases of subject shares by the offeror.

Rule 14e-4 addresses partial tender offers. The rule provides that in the case of a partial tender offer it is unlawful for a person to: (i) tender shares unless at the time of the tender and at the time of any pro-ration of over acceptances the

person has a net long position in (owns) the shares tendered or equivalent, convertible securities; or (ii) tender for the account of another person unless that other person has the shares in question, or the person acting on his/her account has formed a reasonable belief that the person has the shares and will deliver them promptly.

Rule 14e-5 prohibits purchases outside of a tender offer during the pendency of that offer. Rule 14e-5(a) prohibits any 'covered person' from directly or indirectly purchasing or arranging to purchase any subject securities or any related securities except as part of the tender offer. A 'covered person' is defined as the offeror and its affiliates; the offeror's dealer-manager and its affiliates; any adviser whose compensation is dependent on the completion of the offer; and any person acting in concert with the foregoing persons. This prohibition would apply to market makers in the offshore fund's securities if they are covered persons. The prohibition is effective from the time of public announcement of the tender offer until the tender expires.<sup>111</sup>

Precommencement communications are addressed in Rule 14e-8. The rule states that a person will be deemed as having engaged in a fraudulent, deceptive or manipulative act under Rule 14e if that person publicly announces that such person (or the party such person represents) plans to make a tender offer that has not yet been commenced, if the person: (i) makes such announcement without the intention of commencing the offer within a reasonable time and completing the offer; (ii) intends from the announcement to manipulate the market price of the stock of the bidder of the subject company; or (iii) does not have the reasonable belief that the person will have the means to purchase securities to complete the offer.

The application of US tender offer rules to tender offers made for non-US issuers, such as offshore funds, often had the effect of causing non-US bidders to close the offer to US shareholders, thus depriving US investors of the opportunity to realise on investments. To address this perceived problem, the SEC has adopted several exemptive rules intended to encourage issuers and bidders to extend tender offers to the US holders of securities of foreign private issuers.

Specifically, tender offers for the securities of foreign private issuers will be exempt from many provisions of the Exchange Act, and from rules governing tender offers, when US security holders hold 10% or less of the subject securities (calculated in a particular manner as described below). This exception is known as the Tier I Exception. There also exists a so-called Tier II Exception. This exception pertains when US security holders hold 40% or less of the class of securities of the foreign private issuer sought in the offer (calculated in the same manner). In the case of the Tier II Exception, limited tender offer exemptive relief will be available to bidders.

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### Tier I Exception

If US security holders own 10% or less of the shares of an offshore fund (calculated as described below), then the tender offer would not be subject to the requirements of Rules 14e-1 and 14e-2 described above, provided that: (i) US shareholders participate in the tender offer on terms at least as favourable as those offered to other holders; and (ii) the fund provides to US shareholders the tender offer circular or other offering documents, in English, on a comparable basis to that provided to other security holders. For this purpose, all US shareholders of the fund would be counted, regardless of whether they obtained their shares in a secondary market transaction outside of the United States.

In addition, if a tender offer qualifies for the Tier I Exception, then Rule 14e-5, as described above, will also not apply to the tender offer provided that: (i) the offering documents furnished to US holders prominently disclose the possibility of purchases outside of the tender offer, or arrangements to purchase or intent to make such purchases; (ii) the offering documents disclose the manner in which any information about any such purchases or arrangements to purchase will be disclosed; (iii) the offeror discloses information in the United States about any such purchases or arrangements to purchase in a manner comparable to the disclosure made in the target company's home jurisdiction; and (iv) the offeror complies with the applicable tender offer laws and regulations in its home jurisdiction.

There is also an exception to the application of Rule 14e-5 (regardless of whether the tender offer qualifies for the Tier I Exception) to 'Connected Exempt Market Makers' and 'Connected Exempt Principal Traders' as used in the (London) City Code.

In determining the US ownership of the fund, persons owning more than 10% of the securities of the fund, both US and non-US, would be excluded from the calculation. Therefore, a calculation to determine the percentage of US ownership, for the purposes of the Tier I Exception, must exclude any shareholder's interest which is in excess of 10% of the target company's outstanding securities.<sup>112</sup>

The rules for the Tier I and II Exceptions recognise that shares of a target company may be held in a nominee's name. As a general principle, the offeror must try to look through record ownership of brokers, dealers, banks or nominees which appear as record owners of the securities of the fund in order to determine residency of the actual customers for which the dealers, banks or nominees hold the securities.

However, in order to limit the burden on the foreign entity, the Rule requires that the bidder need make this enquiry only of banks, brokers and nominees located in: (i) the United

States; (ii) the issuer's home jurisdiction; and (iii) the primary trading market for the issuer's securities if different from the issuer's home jurisdiction. The bidder may assume that banks, brokers and nominees located in other jurisdictions hold for persons resident in those jurisdictions (ie, for non-US persons).<sup>113</sup>

If, after reasonable enquiry, the offeror remains unable to obtain information about the nominee's customer accounts, the offeror may rely on a presumption that the customer accounts are held for persons resident in the nominee's principal place of business. Notwithstanding the preceding, as a general principle, if the issuer has reason to know that securities are being held in a certain manner to avoid certain provisions of the Exchange Act, the issuer must count all beneficial owners of such securities as record owners.

An important question left open by the regulations is how the bidder judges the existence of 10%+ holders where there are nominee holdings. A 22% nominee holder could hold for two 11% holders, both of whom would be excluded from the calculation, or for ten 2% holders, none of whom would be excluded. It would seem reasonable that the burden would be on the bidder to establish some actual knowledge that a record owner who is suspected to be a nominee in fact holds for a number of small owners. In the absence of such actual knowledge, presumably the record owner must be treated as being excluded from the calculation if it holds more than 10%.

### Tier II Exception

A Tier II Exception will apply to a tender offer for an offshore fund if US security holders (calculated as described above) hold less than 40% of the shares of the offshore fund. Many of the items of relief provided by the Tier II Exception do not apply to a typical tender offer for an offshore fund. Provisions that do or may apply include an interpretation that payment for shares tendered that is made in accordance with the law and practice in effect in the fund's home jurisdiction will be considered 'prompt payment' for the purposes of Rule 14e-1(c). In addition, a Tier II Exception will afford certain flexibility in waiver or reduction of minimum conditions to the offering.

### **AML Considerations**

As currently drafted, the proposed US Treasury regulations that would apply new US AML requirements to unregistered investment companies would apply to offshore funds if, *inter alia*, the fund 'sells ownership interests to a US person'. While amplifications or modifications of this standard may be forthcoming in the final regulations or in interpretations adopted by the US Treasury, it would currently appear that a fund that does not directly sell shares to US persons would not become subject to the new AML regulations solely by reason of its shares being transferred to a US person.

### ***Non-public Offerings of Shares of an Offshore Fund in the United States***

When an offshore fund deliberately sells its shares in the United States, that additional contact results in a wider variety of US tax and regulatory concerns, affecting both the offshore fund and its US investors. Those affecting the offshore fund directly are of principal concern for the fund, but those affecting its US investors must also be addressed if the fund is effectively to sell its shares in the United States. The fund itself faces regulatory issues under the Securities Act, the Investment Company Act, new US AML Laws and, to some extent, state securities laws. The US investors in the fund face the issue of the US taxation of their income and gains from the fund. Both the managers of the fund and its investors can also be affected by certain provisions of US pension regulatory law if certain US pension funds invest in the offshore fund. Although sales of shares in the fund will not materially change the regulatory position of a US investment manager of the fund that is registered under the Advisers Act, there will be important implications for that same adviser if the fund invests in commodities and the adviser is registered as a CPO or CTA under the CEA. Finally, those responsible for the distribution of the fund in the United States may become subject to regulatory requirements of broker/dealer registration under the Exchange Act.

### ***Securities Act***

#### Sales of Offshore Fund Shares

The Securities Act is the principal US federal law governing the initial issuance and sale of securities. Interests in an offshore fund in virtually every instance will be considered securities under the definition of that term in the Securities Act. Securities may not be offered in the United States by use of the means of interstate commerce unless: (i) registered under the Securities Act pursuant to a registration statement meeting the requirements of s. 6 of the Securities Act; or (ii) an exemption from registration is available. A registration under s. 6 of the Securities Act would be undertaken only in the context of a public offering of the shares of the offshore fund in the United States, currently a practical impossibility. Accordingly, an offshore fund selling its shares in the United States must seek an exemption from registration under the Securities Act. The exemptions that may be available to an offshore fund include the statutory private placement exemption under s. 4(2) of the Securities Act and the 'safe harbour'<sup>114</sup> exemption under Regulation D<sup>115</sup> under the Securities Act.<sup>116</sup> For the reasons described below, most offshore funds will use the Regulation D safe harbour exemption.

Section 4(2) of the Securities Act provides an exemption from registration for transactions by an issuer not involving a public offering, ie, private placements. The text of the statutory provision is brief and the case law has not clearly explicated the precise standards for obtaining the private placement

exemption.<sup>117</sup> Rules of thumb concerning the number of offerees and purchasers have grown, but without statutory or regulatory authority to underpin them. Certain statements can be made with reasonable certainty. An offshore fund offering privately<sup>118</sup> in the United States only to a limited number of US entities that are substantial, sophisticated institutional investors, such as insurance companies, may rely on the statutory exemption of s. 4(2). However, offshore funds often seek a wider range of potential investors, including non-institutional investors and entities whose status as a traditional institutional investor may not be clear (eg, family partnerships, holding companies, trusts, etc). It is likely that US legal counsel for the offshore fund will recommend seeking the safe harbour provisions of Regulation D.

Regulation D<sup>119</sup> incorporates safe harbour rules relating to several statutory exemptions, but the safe harbour rule of most interest to offshore funds is that set forth in Rule 506, which provides the safe harbour exemption for s. 4(2) of the Securities Act. Under Rule 506, an offshore fund may sell its shares to no more than 35 non-accredited investors and, subject to the considerations noted below, to an unlimited number of 'accredited investors'.<sup>120</sup>

If securities are offered to non-accredited investors, Regulation D requires the use of disclosure materials that conform to certain standards that are generally similar to those governing disclosures in registered offerings. The documentation used in the offer of shares of the offshore fund outside of the United States generally will not meet some of such requirements. To avoid the cost of changing that documentation to meet such standards, many funds limit their offerings to accredited investors. As long as the offering is limited to accredited investors, Regulation D does not impose any particular informational requirements in the disclosure documents. However, the anti-fraud provisions of the US federal securities laws<sup>121</sup> referred to above still apply and carry civil and criminal liability for their violation. Such rules generally require the inclusion of all material facts and prohibit the making of any untrue statement of a material fact or the omission of any material fact necessary in order to make the statements in the offering materials, in light of the circumstances in which they are made, not misleading. Many offshore funds making private placements in the United States employ a US 'wrapper', usually termed a 'United States Private Placement Memorandum', which sets forth certain securities law, tax and other disclosures to the US investors and also incorporates the disclosure documentation used by the fund outside the United States. The United States Private Placement Memorandum often also encloses a form of investment letter or US subscription agreement to be signed by the US investor that takes the place of the subscription agreement used by the fund outside of the United States and that also contains representations by the US investor that are necessary in connection with the private placement exemption.

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Securities issued in a private placement must not be offered pursuant to general solicitation or advertising, nor by means of any seminar or meeting to which participants have been called by general solicitation or advertising. Normally, a private placement is made by discreet solicitation of institutions and others with whom the issuer, the sponsor of the offering or someone acting on their behalf has a prior relationship.

The staff of the SEC have issued certain interpretative letters<sup>122</sup> in which they have indicated that, in order to avoid a general solicitation, there should be a substantive, pre-existing relationship between the offeree and the issuer or someone acting on the issuer's behalf in the offering. The purpose of requiring such a pre-existing relationship is to allow the issuer or those acting on its behalf to form a reasonable view as to whether the investment may be suitable for the offeree. Although there is no direct authority on the matter, some US legal counsel take the position that the extent of the required pre-existing relationship is related to the nature of the offeree. A slight relationship with a major insurance company would likely enable an offeror to form a reasonable view that the insurance company would be a suitable investor. A greater pre-existing relationship would be necessary in the case of an individual. The difference relates to the offeree's apparent ability and sophistication in making investments of this type. Funds often include in the representations to be made by a US purchaser that the purchaser generally knows those acting on behalf of the issuer in a securities-related connection.

It is normal for the issuer in a private placement to take steps to police the restrictions on transfer of shares issued to purchasers in the private placement. This is accomplished by placing a legend on the certificates representing the securities privately placed, which refers to the restrictions on transfers. Instructions are then issued by the issuer to the registrar of its shares that no securities represented by a legended certificate may be transferred without compliance with the resale restrictions noted below.<sup>123</sup> Many funds whose shares are eligible for holding through Euroclear or CEDEL take the step of making the facilities of such clearing houses unavailable to US purchasers, as it is normally impossible to track US ownership through such clearing houses.

### Resales of Offshore Fund Shares Privately Placed in the United States

Securities issued by an offshore fund in a private placement in the United States are 'restricted securities' — ie, they may not be resold by the purchaser other than pursuant to registration under the Securities Act or pursuant to an exemption from such registration. This has important implications for the fund, since, in order to obtain the private placement exemption, the fund must take steps to establish that the purchasers are not 'underwriters' within the meaning

of that term as defined in the Securities Act — ie, persons who are purchasing interests in the fund with a view to their further distribution. The usual procedure is for the purchasers to agree not to transfer the shares in the fund other than in accordance with certain exceptions. While this is unimportant from a practical point of view for an open-ended fund that will buy back its own shares, the restrictions are still important in establishing eligibility for the private placement exemption.

There are various ways in which an offshore fund could allow resales of its shares by US purchasers without prejudicing its reliance on the private placement exemption.

- For an open-ended fund, transfers to the fund in redemption of the shares would be allowed.
- The purchaser may resell the shares in a further private placement.<sup>124</sup> This is a cumbersome procedure, normally requiring opinions of legal counsel that the transfer may be made without registration under the Securities Act.
- Shares of the offshore fund may be resold outside of the United States in a transaction complying with the resale safe harbour provisions of Regulation S.<sup>125</sup> As discussed above, for resales of shares of an offshore fund, securing such safe harbour treatment would require only that the sale be made in an 'offshore transaction' as defined in Regulation S and that neither the seller nor anyone acting on its behalf engage in any 'directed selling effort' in the United States. In the case of shares traded on a 'designated offshore securities market',<sup>126</sup> the requirement for an 'offshore transaction' could be satisfied by a normal course transaction on such a securities market in which neither the seller nor anyone acting on its behalf knows that the transaction has been pre-arranged with a buyer in the United States. Any other offshore transaction, within the meaning of that term under Regulation S, would also qualify.
- Interests in the offshore fund may also be resold pursuant to Rule 144A<sup>127</sup> to a 'qualified institutional buyer'<sup>128</sup> either within or outside of the United States in a transaction meeting the requirements of Rule 144A. A qualified institutional buyer is one of a list of types of institutions set forth in Rule 144A that owns and invests on a discretionary basis at least US\$100 million in securities of entities that are not affiliated with the entity. There is a modest informational requirement in connection with resales under Rule 144A.<sup>129</sup> Ordinarily, these information requirements can be met by provision of the fund's Offering Circular or other offering documentation and the fund's audited financial statements. It is not unusual for the fund



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to undertake to the US purchasers of its shares that it will make available to such purchasers and/or qualified institutional buyers to whom the shares may be transferred the information necessary to meet the requirements of Rule 144A.

### Simultaneous US Private Sales and Public Sales Outside the United States

Contemporaneously with the private placement of their shares in the United States, many offshore funds offer and sell their shares outside of the United States in transactions that would likely not meet the requirements of a US private placement. It is therefore important that the US and non-US offerings not be integrated. Such integration will not occur if the offering outside the United States involves offers and sales outside of the United States under Regulation S, thus removing those offers and sales from the registration provisions of the Securities Act. As discussed above, the Regulation S issuer safe harbour can be achieved if the shares are sold in an offshore transaction and there are no directed selling efforts in the United States. Bona fide private placement activities in the United States will not be considered directed selling efforts for the purposes of determining whether the non-US offering meets the requirements of Regulation S. An offshore fund that is considering a simultaneous public or quasi-public offering outside of the United States and a private placement in the United States should include in its offshore distribution agreements a representation that those distributing the shares of the fund outside of the United States will do so only in offshore transactions as defined in Regulation S and will not undertake directed selling efforts in the United States.

Failure to keep the solicitation of US investors within the requirements for a private placement would have two major consequences. First, the offering in the United States could be deemed a public offering requiring registration under the Securities Act. Among the consequences of that would be a one-year rescission right — essentially a one-year money-back guarantee for the investor. Secondly, promotional activities in the United States which exceeded proper solicitation in a private placement might be deemed 'directed selling efforts' in the United States, depriving the non-US offering of the benefits of the issuer safe harbour rule under Regulation S.

### **State Securities Law Compliance**

In addition to seeking an exemption under federal securities laws, an offshore fund selling its shares in the United States must take care to ensure that its US offering is not subject to registration under the securities laws of any state or other jurisdiction within the United States.<sup>130</sup> Until the passage of the NSMIA, federal securities legislation did not preempt states from requiring parallel registration of securities issuances under state law. The NSMIA added s. 18 of the Securities Act, which provides that no state law requiring

registration of securities shall apply to a 'covered security'. Among others, covered securities include securities that are exempt from registration under the Securities Act by reason of SEC rules and regulations adopted under s. 4(2) of the Securities Act. Thus, an issuance of shares in the United States by an offshore fund that is exempt by reason of full compliance with Regulation D will be exempt from state securities law registration. A transaction exempt under the statutory 4(2) provision alone — ie, without full compliance with Regulation D — will not be entitled to this pre-emption of state law.

Prior to the enactment of the NSMIA, offshore funds had to seek exemptions from state securities laws in the same manner as they seek exemption from registration at the federal level. Offshore funds that do not comply fully with Regulation D must still seek such exemptions on a state-by-state basis. Available exemptions include institutional investor exemptions and limited offering exemptions. A limited sale by an offshore fund to a handful of US institutional investors can often be exempted at the federal level by the statutory s. 4(2) exemption and an institutional investor exemption at the state level. The state limited offering exemptions roughly parallel the s. 4(2)/Regulation D requirements and often require the filing of Form D. The exemptions in some states require no filing or other action by the offshore fund (self-executing exemptions). Other states require notice filings and/or submissions to jurisdiction. While the NSMIA exempted covered securities from registration at the state level, it did not prohibit the states from requiring notice filings and filing fees. Accordingly, state securities laws must be individually examined by US counsel for the offshore fund to determine compliance requirements. The NSMIA also did not prohibit states from prosecuting issuers of securities in covered transactions under state law in the case of securities fraud.

### **Investment Company Act**

As discussed in the section entitled *US Shareholders Other Than from Offerings in the United States*, above, an offshore fund making a private placement in the United States must conduct the offering in such a manner as to avoid the need to register under the Investment Company Act. The requirement for such registration can be avoided, under the terms of the *Touche Remnant* no-action letter, by limiting the number of US beneficial shareholders of the fund<sup>131</sup> to 100<sup>132</sup> or fewer.<sup>133</sup> In the parlance that has grown up around the SEC's interpretation of ss. 3(c)(1) and 7(d), this is referred to as the offshore fund depending upon s. 3(c)(1) for its exemption from Investment Company Act registration.

Until the *Goodwin, Proctor and Hoar (Goodwin Proctor)* no-action letter,<sup>134</sup> some controversy existed as to exactly how a relevant US beneficial shareholder is defined for the purposes of the 100 US beneficial holder limitation. The *Touche Remnant* no-action letter used the term 'US

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resident' beneficial shareholder. Later, when Regulation S was promulgated, with its definition of US person for other purposes, some practitioners adopted that definition for the purposes of determining compliance with the *Touche Remnant* standards. The *Goodwin Proctor* no-action letter settled the question by establishing that the relevant definition is the Regulation S definition of US person, subject to certain qualifications.<sup>135</sup>

The Regulation S definition of a US person is generally based on territorial notions. While US citizens are not considered US persons when permanently residing outside of the United States, under both Regulation S and for the purposes of determining the 100 US beneficial holder limitation, US citizens who purchase shares of an offshore fund while temporarily outside of the United States are counted towards the 100 US beneficial holder limitation.<sup>136</sup> Also, as under Regulation S, US branches and agencies of foreign companies and partnerships are considered US persons that count towards the 100 US beneficial holder limitation.

In the case of a shareholding in the offshore fund by a 'company',<sup>137</sup> the company is considered as a single beneficial owner of the offshore fund, except in two sets of circumstances. In these two situations the offshore fund must 'look through' the company and count the shareholders of the company as beneficial owners of the offshore fund. Thus, if those beneficial owners are US persons, they would count towards the 100 US beneficial owner limitation. The first set of circumstances arises if the company owns 10% or more of the shares of the offshore fund and if the company itself is an investment company within the Investment Company Act's definition, or would be within the definition, but for the exceptions from the definition set forth in s. 3(c)(1) (fewer than 100 shareholders) or s. 3(c)(7) (qualified purchasers — see below). The other circumstance in which the offshore fund must look through a shareholder that is a company is if that company has been formed or recapitalised for the purpose of making the investment in the offshore fund.<sup>138</sup>

The NSMIA created an alternative to the 's. 3(c)(1)' method of an offshore fund avoiding the requirement to register under the Investment Company Act without limiting the number of US beneficial shareholders to 100. By adding s. 3(c)(7) to the Investment Company Act, NSMIA created a new type of private investment company in the United States, sometimes referred to as a 'qualified purchaser' fund. An entity otherwise meeting the definition of investment company under s. 3(a) of the Investment Company Act is excluded from the definition (and thus from the need to register under the Investment Company Act) if it does not make or propose to make a public offering of its securities in the United States and its securities are owned exclusively by 'qualified purchasers'.<sup>139</sup> Generally, a 'qualified purchaser'<sup>140</sup> is an individual or a family company<sup>141</sup> that owns not less than US\$5 million in 'investments'; a trust, if both the trustee or

another person with investment discretion and all settlors or other contributors are qualified purchasers; or another entity that owns and invests on a discretionary basis not less than US\$25 million in 'investments'.<sup>142</sup>

It is possible for a 's. 3(c)(1)' or 's. 3(c)(7)' company to be a qualified purchaser.<sup>143</sup> In that case, the investor can count towards its US\$25 million of investments the unfunded investment commitments from its investors, providing that the commitments are made pursuant to binding agreements. This facilitates 'fund of fund' structures, which are particularly prevalent in the venture capital or direct investment field. The SEC staff has issued a no-action letter indicating that a qualified defined contribution plan can be treated as a qualified purchaser for s. 3(c)(7) purposes, in which case the s. 3(c)(7) fund would not be required to treat each participant in the plan as a qualified for s. 3(c)(7) purposes.<sup>144</sup> The SEC staff has emphasised, however, that the plan must be qualified under s. 401(k) of the Code and subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). In addition, the plan trustee must be fiduciaries under ERISA and make all investment decisions for the plan, and the investment options offered to plan participants must not be used to facilitate the individual investment decisions of plan participants into any s. 3(c)(7) fund.

Certain s. 3(c)(1) funds existing at the time of the passage of the NSMIA, including offshore funds that depended at that time on the 'fewer than 100 US investor' rule, can convert into s. 3(c)(7) funds, retaining their pre-existing non-qualified purchaser investors, but not being subject to the 100 US beneficial shareholder limitation. Such funds are referred to as 'grandfathered' s. 3(c)(1) funds. The only non-qualified purchasers that a grandfathered s. 3(c)(1) fund can have are fewer than 100 non-qualified purchasers that acquired their shares in the fund on or before 1 September 1996. All other shareholders must be qualified purchasers. In addition, the fund must disclose to each of its shareholders that it intends to convert to a s. 3(c)(7) fund and give each of its shareholders the opportunity to redeem their interests in the fund at net asset value.

An offshore fund seeking to rely on s. 3(c)(7) to avoid registration under the Investment Company Act need only confirm that all of its US beneficial shareholders (those who would count under the interpretations of the *Goodwin Proctor* and *IFIC* no-action letters) are qualified purchasers. Other shareholders of the offshore fund need not meet the qualified purchaser requirements.

### **AML Considerations**

Private placements of shares of an offshore fund in the United States will almost certainly constitute selling an ownership interest to a US person. Such an activity is sufficient to subject the offshore fund to the new US AML requirements

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under the BSA as amended by the PATRIOT Act. See AML considerations in the section entitled *US Shareholders Other Than from Offerings in the United States*, above.

### **Tax Considerations for US Investors in an Offshore Fund**

In placing its shares in the United States, an offshore fund must be aware of the tax implications for US persons of holding shares of the offshore fund. These considerations are often part of the disclosure materials in the 'US wrapper' for the offshore fund. If the offshore fund is an entity that is considered a corporation for US tax purposes, there will be potential adverse tax implications for US taxpaying shareholders that invest in the fund. If the offshore fund is organised in a form recognised as a partnership for US tax purposes, there will be tax implications for US investors that are tax-exempt entities. In some cases, affirmative actions by the offshore fund can eliminate or ameliorate the unfavourable tax consequences for US investors.

#### General PFIC Rules

For US tax purposes, an offshore fund in corporate form normally will be characterised as a passive foreign investment company (PFIC).<sup>145</sup> US taxpayers that invest in a PFIC generally will be taxed in a burdensome manner unless they make an election to be taxed in an alternative manner with respect to their investment in the PFIC.

A US taxpaying investor in a PFIC that fails to make either of the elections noted below (a 'non-electing US investor') will not be subject to current US tax on profits earned by the PFIC, but will be taxed on the disposition of such shares at a gain or when the PFIC makes certain types of distributions. The amount of such gain or distribution is treated as ordinary income earned pro rata over the non-electing US investor's holding period for its PFIC shares, regardless of whether it was a capital gain in the hands of the fund. In short, what would otherwise have been capital gains to the US shareholder on redemption of his shares will instead be taxed at ordinary income rates. The portion of such ordinary income considered to be earned in prior tax years is subject to tax at the highest marginal rates in effect for such years (the 'deferred tax liability'). The non-electing US investor must also pay an interest charge with respect to the deferred tax liability at a rate of 3% above the market rate for short-term US government securities — a rate generally above-market and therefore quite burdensome. A non-electing US investor cannot deduct losses realised by the PFIC, but may claim a capital loss upon disposition of its PFIC shares.

#### Qualified Electing Fund

A US investor in a PFIC may elect to treat the PFIC as a qualified electing fund (QEF). If the QEF election is made, the US shareholder will be taxed currently on its pro rata share of the fund's earnings in the following manner. The electing US shareholder must include in gross income, as ordinary

income, its pro rata share of the ordinary earnings (including net short-term capital gains) of the offshore fund. Such US investor must also include in gross income, as long-term capital gain, its pro rata share of the 'net capital gain' of the offshore fund.<sup>146</sup> During each year in which the QEF election is in effect, the foregoing amounts are included in the gross income of the US investor for the taxable year in which, or with which, the taxable year of the offshore fund ends.<sup>147</sup>

The offshore fund must, in effect, co-operate with the US shareholder in order for the US shareholder to make the QEF election. In order for a US investor to make and maintain the QEF election, such investor must receive a 'PFIC Annual Information Statement' from the offshore fund and attach such statement to its timely filed US federal income tax return (including extensions).<sup>148</sup>

The PFIC Annual Information Statement should contain the following information:

1. The first and last days of the taxable year of the PFIC to which the information statement applies (PFIC taxable year). The information should be provided for the PFIC taxable year which ends in the preceding calendar year or which is coincident with the preceding calendar year.
2. The shareholder's pro rata shares of 'ordinary earnings'<sup>149</sup> and 'net capital gain'<sup>150</sup> of the PFIC for the PFIC taxable year or sufficient information to enable the shareholder to calculate the shareholder's pro rata share of such income or a statement that the foreign corporation has permitted the shareholder to examine the foreign corporation's accounting records for the purpose of determining the PFIC's income and the shareholder's pro rata share of such income. The foregoing types of income should be calculated in accordance with US income tax principles.<sup>151</sup>
3. The amount of cash and the fair market value of any other property distributed or deemed distributed (eg, a pro rata repurchase of shares would be a 'deemed distribution') to the shareholder during the PFIC taxable year.
4. A statement that the PFIC will permit the shareholder to inspect and copy the PFIC's permanent books of account, records and such other documents as may be maintained by the PFIC that are necessary to establish that the PFIC's ordinary earnings and net capital gain are calculated in accordance with US income tax principles.

#### The Mark-to-Market Election

A second election, the 'mark-to-market election', was added in the TRA for US taxpaying investors in an offshore fund.

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Section 1296 of the Code permits an electing shareholder to include gains or losses on 'marketable stock' in a PFIC owned by the US shareholder at the close of such shareholders' taxable year. Under this election, the character of such gain or loss is treated as ordinary. Thus, US shareholders that are unable to make a QEF election, because the fund will not provide an annual statement, would be able to avoid the unfavourable consequences of being a non-electing US investor described above. The regulations promulgated under s. 1296 define the term 'marketable stock' as PFIC stock that is regularly traded on a qualified exchange or other market. For these purposes, a class of stock is regularly traded for any calendar year during which such stock is traded, other than in *de minimis* quantities, on at least 15 days during each calendar quarter. Under new proposed regulations, stock issued in a public offering will be regularly traded for the calendar year in which the public offering is initiated if such stock is traded, other than in *de minimis* quantities, on one-sixth of the days remaining in the quarter in which the offering occurs and on at least 15 days during each remaining quarter of the calendar year. The proposed regulations further provide that stock issued in a public offering initiated in the fourth quarter of the calendar year will be regularly traded for such calendar year if the stock is traded, other than in *de minimis* quantities, on the greater of one-sixth of the days remaining in the quarter, or five days. The term 'qualified exchange or other market' is defined as a national exchange registered with the SEC or the national market system established pursuant to s. 11A of the Securities Act of 1934 or a foreign exchange regulated or supervised by a governmental authority of the country in which the market is located and which meets certain criteria aimed to avoid fraud or market manipulation.

Shares of a PFIC will also be considered 'marketable stock' if the shares are redeemable at net asset value and the offshore fund has certain features that are characteristic of US registered open-ended investment companies. The requirements for shares of an open-ended offshore fund to have 'marketable stock' are as follows:

- the fund must have more than 100 shareholders;
- the fund must have shares that are available for purchase by the general public at NAV and with a minimum initial investment of not more than US\$10,000;
- the fund's NAV must be published at least on a weekly basis;
- the fund must have an annual audit by an independent auditor, and there must be public dissemination of the audited financial statements;
- the fund must be supervised or regulated by a foreign government agency or instrumentality that has broad inspection and enforcement authority and effective oversight over investment companies;

- the fund must not have debt outstanding other than in *de minimis* amounts; and
- the fund must have at least 90% of its assets devoted to the production of passive income.

### Publicly-traded Partnerships

Although structuring an offshore fund as a partnership generally avoids the application of the PFIC regime, certain partnerships that are deemed to be 'publicly-traded' will be characterised as corporations and, therefore, subject to all the federal income tax provisions applicable to corporations, including PFIC status. The purpose of this rule was to protect the two-tier corporate tax system from being eroded by publicly-traded corporations converting to publicly-traded partnerships that were taxed only at the partner level.

A publicly-traded partnership is defined as any partnership the interests of which are: (a) traded on an established securities market; or (b) readily tradable on a secondary market or the substantial equivalent thereof. An exception to the definition applies if 90% or more of the gross income of the partnership consists of 'qualifying income'. Such income is generally passive income such as interest, dividends and capital gains. The 90% exception, however, does not apply to certain types of partnerships that could qualify as 'regulated investment companies' if they were organised as US corporations.

### Tax Considerations for Tax-exempt Investors in Offshore Funds

Tax-exempt institutional investors in the United States, such as charities and university endowments, are generally exempt from tax on income from investments that finance their non-profit purposes. However, when such investors are considered to be involved in businesses that are not associated with their taxable purposes, they are taxable on income that they receive from such businesses, termed 'unrelated business taxable income' (UBTI). A tax-exempt investor cannot recognise UBTI through an offshore fund characterised as a corporation for US tax purposes. However, an offshore fund that is structured as a partnership for US tax purposes can generate UBTI for a US tax-exempt investor. If the offshore fund is considered to be engaged in an active business, the tax-exempt investor's proportionate share of the income from that active business will be taxable to the tax-exempt investor. The typical offshore fund that restricts its activities to portfolio investments is unlikely ever to generate UBTI.

However, offshore venture capital funds are often in partnership form and some are quite involved in the businesses of their portfolio companies. If the offshore fund itself receives consulting, investment banking or other fees for services from the portfolio companies, such fees would likely constitute UBTI for a US tax-exempt investor in the fund. If, however, the services are performed and the fees



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are received by the general partner of the fund or associated management companies, the tax-exempt shareholders should not recognise UBTI, even if the general partner and/or management companies reduce their fees to the investment fund by an equivalent amount.<sup>152</sup>

UBTI can also occur in other offshore funds in partnership form, such as those investing in real estate and oil and gas.

In addition to UBTI, a US tax-exempt investor can realise taxable income from the disposition of, or income derived from, debt-financed property, ie, property owned by the investor that has been purchased with borrowed funds. This income is referred to as 'unrelated debt-financed income' (UDFI). When a US tax-exempt entity invests in an offshore fund in partnership form, the investor can realise UDFI if the fund has leveraged its investments. Such debt financing is particularly common in buy-out funds. The adverse US tax consequences for the tax-exempt investors can be avoided if the debt is incurred at the level of a holding company owned by the fund, provided that the holding company is an entity that would be characterised as a corporation for US tax purposes.

Because of the potential of UBTI or UDFI for US tax-exempt investors in an offshore fund in partnership form, and because of a potential danger of non-US investors in an offshore fund in partnership form becoming US taxpayers and tax filers if the fund is considered to be engaged in trade or business, a special 'feeder' vehicle is often created for such investors' participation in an offshore fund in partnership form. The feeder vehicle is normally an offshore company (treated as a corporation for US tax purposes) that becomes a limited partner in the partnership. No UBTI or UDFI will flow through the feeder vehicle, and if the partnership is considered to be engaged in trade or business in the United States, only the feeder vehicle and not the non-US investor becomes a US taxpayer and tax filer. Such feeder vehicle may incorporate the letters 'FTE' (for foreign and tax exempt) in its name.

### **ERISA Considerations**

Among the largest institutional investors in the United States are pension and other benefit plans of US employers that are subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA).<sup>153</sup> Plans subject to ERISA (ERISA plans) are usually among the US institutional investors sought out by offshore funds making an offering in the United States. However, the presence of ERISA plans as investors in an offshore fund can raise important issues for the fiduciaries to the ERISA plan, as well as for the fund itself and its directors and investment manager.

The management of the assets of ERISA plans is subject to stringent rules designed to assure safety and prudence of investments and to avoid actual and potential conflicts of interest between the ERISA plan and those that act on its behalf to manage its investments. Those requirements are set forth in the text of ERISA and in regulations adopted by the US Department of Labor (DOL), which administers the non-tax portions of ERISA.

In 1986, the DOL issued final regulations regarding the definition of 'plan assets' (the Plan Asset Regulations). The Plan Asset Regulations provide guidance as to what constitutes the assets of an ERISA benefit plan for the purposes of, among other things, the fiduciary responsibility provisions of ERISA and the prohibited transaction rules of s. 4975 of the Code. The Plan Asset Regulations set forth the general rule that when a plan invests in another entity, the plan's assets include its investment in such other entity, but do not include the underlying assets of such other entity. However, the Plan Asset Regulations provide that in the case of a plan's investment in an investment fund that is not an investment company registered under the Investment Company Act or whose shares are not 'publicly offered',<sup>154</sup> the plan's assets will be deemed to include both its direct interest in the entity and an undivided interest in each of the assets of such entity, unless it is established that the entity is an operating company (within the meaning of the Plan Asset Regulations) or that equity participation in the entity by 'benefit plan investors' is not 'significant'.

The consequences of an offshore fund's assets being considered assets of an ERISA plan are that the offshore fund and its directors and investment manager must conform to the requirements of ERISA as though they had directly contracted with the ERISA plan to manage its assets.<sup>155</sup>

The underlying assets of an offshore fund in which an ERISA plan invests will not be considered to be the assets of such a plan if equity participation in the entity by 'benefit plan investors' is not 'significant'. For this purpose, the Plan Asset Regulations provide that equity participation in an entity by benefit plan investors is significant on any date if, immediately after the most recent acquisition of any interest in the entity, 25% or more of the value of any class of equity interest in the entity is held by benefit plan investors.

For the purposes of the Plan Asset Regulations, the term 'benefit plan investor' means any employee benefit plan (as defined in ERISA s. 3(3)) whether or not such plan is subject to ERISA. This would include — eg, ERISA plans themselves; government plans, such as state employee retirement plans; retirement plans of churches; and retirement plans of international organisations, such as the World Bank and the IMF. The preamble to the Plan Asset Regulations also implies that 'foreign plans' must be

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included in the collective term 'benefit plan investors'. For this purpose, 'foreign plans' has come to have an accepted meaning of all pension and benefit plans of employers, governmental and private, located outside of the United States.<sup>156</sup> This can be significant for offshore funds, since many of their investors are pension plans from outside of the United States. The practical import of this rule is that if there is ERISA plan participation in an offshore fund (no matter how small the percentage participation), and if all benefit plan investors in the offshore fund (including non-US pension funds) in the aggregate hold 25% or more of the shares of the offshore fund, then the plan assets regulation will apply and the assets of the offshore fund will be considered assets of the ERISA plans investing in the fund.<sup>157</sup>

Even if benefit plan investor equity participation in an offshore fund is significant (ie, 25% or greater), an offshore fund can escape the effects of the Plan Asset Regulations if it can be considered an 'operating company' for the purposes of those regulations. As a practical matter, this exception to the Plan Asset Regulations will be available only to venture capital or buy-out funds or to real estate funds and will not be available to offshore funds making portfolio investments.

The Plan Asset Regulations will not apply if the offshore fund is considered a 'venture capital operating company'. In order to be a venture capital operating company, at least 50% of the assets of the fund during an annual measuring period must consist of investments in operating companies in respect of which the offshore fund has 'management rights'.

While the term 'management rights' is not defined with precision, it is generally acknowledged that the right to name a director to the board of the portfolio company constitutes 'management rights'. Thus, if an offshore venture capital or buy-out fund can obtain the right to nominate directors on the boards of companies constituting more than 50% of its assets and actually exercises those rights in respect of one or more of the companies, it should be considered a venture capital operating company for the purposes of the Plan Asset Regulations.

The Plan Asset Regulations also will not apply if the offshore fund is considered a 'real estate operating company'. In order to be considered a real estate operating company, the offshore fund must have at least 50% of its assets (measured annually during an established measuring period) invested in real estate that is managed or developed by the offshore fund or with respect to which the offshore fund has the right to substantially participate in the management or development. Such management and development can be undertaken by independent contractors to the fund and need not be undertaken by employees of the fund itself. Further, in the course of its business, the fund must actually engage in real estate management and development activities.

### **Broker/Dealer Considerations for Persons Selling Shares of an Offshore Fund in the United States**

When an offshore fund makes an offering of its shares in the United States, a variety of persons may be involved in soliciting US investors. Most commonly, an investment manager sponsors and manages the investments of the fund, and personnel of the investment manager are involved in solicitation of US investors. Sometimes the investment manager is part of an international financial group that includes registered US financial industry affiliates. Often sales of shares of offshore funds are subject to a sales load, which is collected (and sometimes reallocated to sellers of fund shares) by the investment manager that sponsors the fund or by a brokerage affiliate of that investment manager. Those persons involved in the solicitation of US investors to purchase shares of an offshore fund must consider whether they are subject to registration in the United States as broker/dealers.

The Exchange Act defines 'broker' as 'any person engaged in the business of effecting transactions in securities for the account of others ...'. Section 15 of the Exchange Act prohibits a broker from using the US means of interstate commerce to effect transactions in securities or to induce or attempt to induce the purchase or sale of securities unless the broker is registered with the SEC and a member of the NASD.<sup>158</sup>

There is a significant danger that persons conducting solicitation of US investors for offshore funds will be seen to be conducting brokerage activity requiring their registration under the Exchange Act. This can be the case even if no sales load is charged to US investors. The statutory definition of broker does not have a territorial aspect to it; one who engages in the activities described in the definition anywhere is a broker. Thus, the statutory prohibition of a 'broker' using the interstate means to effect transactions in securities without registration could include effecting transactions that are not part of the brokerage business of the person doing the solicitation; ie, where there is no sales load (brokerage commission) charged for the securities transaction effected by the interstate means.

Rule 3a-4 under the Exchange Act is a safe harbour rule providing comfort that certain 'associated persons of an issuer' of securities will not be considered to be engaged in brokerage activities by reason of their involvement in the sales of the issuer's securities. However, the rule usually has limited applicability in the typical circumstances of an offshore fund. In the context of an offshore fund, the rule provides comfort to individuals (ie, natural persons) who are partners, officers, directors or employees: (i) of the offshore fund itself; (ii) if the offshore fund is in partnership form, of a corporate general partner of the offshore fund; (iii) of a

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company or partnership that controls, is controlled by, or is under common control with, the offshore fund. (For this purpose, an investment manager that sponsors and manages the investments of the fund may be considered to control the fund.) The rule provides no comfort to any person other than individuals; it provides no comfort to companies or other entities, such as the investment manager of the offshore fund or its affiliated companies engaged in the distribution of fund shares.

There are three preconditions to obtaining the rule's benefits. The associated person must not: (i) be subject to certain statutory disqualifications;<sup>159</sup> (ii) be compensated in connection with his/her participation by the payment of commissions or other remuneration based either directly or indirectly on the transactions in securities; and (iii) at the time of his/her participation be an associated person of a broker or dealer. Typically, the US sales of the shares of an offshore fund are conducted by persons who are associated with the investment manager that sponsors the fund. In that context, the first pre-condition may well be met. The second precondition may be met, depending upon the way in which the persons are compensated by the investment manager. The third precondition can be difficult. If there is a sales load on the offshore funds sponsored by the investment manager, even if such sales load is not charged to US investors (and even if the funds with a sales load are not those sold in the United States), and if the investment manager receives all or part of that sales load, it may be seen as falling within the statutory definition of broker and thus persons associated with it would not meet the third pre-condition.

Even if the preconditions are met, the rule's benefits extend only to three situations. First, the rule's benefits are available if the associated person restricts his/her activities to sales of shares of the offshore fund to a relatively narrow class of US institutional investors;<sup>160</sup> sells shares pursuant to certain exemptions in the Securities Act that are rarely applicable to an offshore fund;<sup>161</sup> sells shares that are issued pursuant to a merger or plan of reorganisation that is subject to approval of the fund's shareholders; or sells shares pursuant to bonus, profit sharing, stock ownership and similar plans. Secondly, the rule's benefits are available if the associated person's activities in selling securities are sporadic (the person does not participate in sales of securities of any issuer more than once in any 12-month period); the person has other substantial duties with the issuer that will continue to be performed after the issuance is completed; and the person has not been associated with a broker or dealer over the preceding 12-month period. Thirdly, the rule's benefits are available if the associated person's activities are confined to certain clerical and other activities not normally relevant to offshore funds.

The most prudent course for an offshore fund offering its interests to US investors is to engage the services of a

registered broker/dealer in the United States. Rule 15a-6 under the Exchange Act<sup>162</sup> allows the personnel of the investment manager or other sponsor of the offshore fund to engage in certain of the solicitation activities in the United States in conjunction with such a registered broker. Rule 15a-6 permits offshore promoters to solicit securities transactions from 'US institutional investors'<sup>163</sup> or 'major US institutional investors',<sup>164</sup> provided that certain conditions are satisfied.

Transactions resulting from the solicitation must be effected through an intermediary US-registered broker-dealer and certain conditions must be satisfied. The US-registered broker-dealer must be responsible for: (i) effecting the transaction, other than negotiating terms; (ii) issuing all required contract notes (confirmations) and statements to the US institutional investor or major US institutional investor; (iii) extending, or arranging for any extension of, any credit in connection with the transactions; (iv) maintaining the books and records required to be maintained by registered broker-dealers in relation to securities transactions; and (v) complying with the net capital requirements of Rule 15c3-1 under the Exchange Act and the customer protection provisions of Rule 15c3-3 under the Exchange Act (both of which apply to the US-registered broker-dealer).

In addition, the US-registered broker-dealer must participate through an associated person (generally, any principal or registered representative of such broker or dealer) in all oral communications, including telephone conversations, between the offshore promoter and a US institutional investor.<sup>165</sup> This participation in oral communications is not required, however, with respect to communications with major US institutional investors. Any representatives of the offshore promoter travelling to the United States to meet with US institutional investors generally must be accompanied by a representative of the US-registered broker-dealer regardless of whether they are visiting US institutional investors or major US institutional investors. There is, however, one exception to this requirement. In the *Cleary, Gottlieb* no-action letter (see endnote 165), the SEC indicated that an offshore promoter would be permitted, without being accompanied by a representative of a US-registered broker-dealer, to have in-person contacts during visits to the United States with major US institutional investors, so long as the number of days on which such in-person contacts occur do not exceed 30 days per year and the offshore promoter engaged in such in-person contacts does not accept orders to effect securities transactions while in the United States.

The US-registered broker-dealer is responsible for the communications by the offshore promoter representatives. The registered broker-dealer is required to obtain certain specified information with respect to the associated persons of the offshore promoter, and written consent of the offshore promoter and its associated persons for the US-registered broker-dealer to accept service of process for any SEC action

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against them. There is no requirement that the US-registered broker-dealer be affiliated with the offshore promoter.

Further, upon request from the SEC, the offshore promoter must also provide to the SEC any information or documents within its possession, custody or control, together with any testimony of its associated persons that relate to transactions covered by the Rule 15a-6 exemption. Finally, associated persons of the offshore promoter must not be subject to certain statutory disqualifications and the US-registered broker-dealer must make a determination for its files to that effect.

### **Implications of US Sales for Offshore Funds that are Commodity Pools**

As described in the section above entitled *Sales Outside of the United States, Including Sales Activities Conducted from Within the United States and Internet Sales*, an offshore fund that invests in commodities futures contracts, such as stock exchange index futures, would be considered a commodities pool. So long as the offshore fund has no connection with the United States other than purchasing commodities on US commodities exchanges through US futures commission merchants (ie, no US investors, no US meetings or administrative activity, no capital contributed, directly or indirectly, from US sources, no US manager and no US directors),<sup>166</sup> the operators of the pool should not be subject to registration as CPOs.<sup>167</sup> However, if shares of the pool are sold to US investors, no matter how few in number, those persons operating the pool, even if located outside of the United States, are generally subject to registration as CPOs.<sup>168</sup> After registration, such persons are subject to the reporting, record-keeping and disclosure requirements relating to all of the commodity pools that they operate, regardless of whether they have US persons as investors. Under the terms of CFTC Advisory Opinion 18-96, such a registered offshore CPO should be able to obtain extensive relief from these compliance burdens with respect to the operated pools that have no US investors.

Limited relief from the normal compliance burdens in respect of a commodity pool is available under CFTC Regulation 4.12 if the following conditions are met. First, the interests in the pool must be offered and sold pursuant to applicable securities regulations. Secondly, the pool must generally and routinely engage in the buying and selling of securities and derivatives. Thirdly, the pool must not invest more than 10% of its assets in commodity futures and commodity options. Fourthly, the pool must trade commodity interests in a manner incidental to its securities activities. Finally, each investor and potential investor in the pool must be informed of the restrictions stated in the third and fourth requirements. If such conditions are met, and an exemption notice is filed together with the pool's disclosure document; (i) the CPO may use an offering memorandum for the commodity pool that differs from the requirements of the normal disclosure

document; (ii) the CPO may provide to investors in the pool, in lieu of a more extensive account statement, a quarterly statement indicating the NAV as of the end of the quarter and the changes in NAV during the quarter; and (iii) requirements for the pool's annual report and certain record-keeping rules are also relaxed.

More extensive relief from the compliance burdens is available under CFTC Regulation 4.7. Relief under that regulation is available if the CPO offers and sells interests in the pool only to 'qualified eligible persons'<sup>169</sup> in an offering that qualifies for exemption from registration pursuant to applicable securities laws and which is offered and sold without marketing to the public in the United States. A pool in respect of which relief is claimed under Regulation 4.7 need not limit its commodity futures contracts or commodities options to any given percentage of its assets and its investments in commodities need not be merely incidental to its other trading strategies. If the requirements for Regulation 4.7 are met and a claim for exemption is filed with the CFTC (no need to file the disclosure document), then the operator of the pool is exempt, with respect to that pool, from the disclosure requirements to investors, provided that if an offering memorandum is used in connection with the offering, the memorandum must contain all disclosure necessary to make the information therein not misleading. The memorandum must also contain a prominent statement on its front cover that the pool is operating under a Regulation 4.7 exemption. The operator is also subject to relaxed quarterly and annual reporting requirements and is relieved from certain record-keeping requirements. Claims for exemption under CFTC Regulations 4.12 and 4.7 must generally be filed prior to the solicitation of investors and are effective on filing.

The requirements of registration as a CPO or CTA apply in respect of any commodity pool, ie, any investment vehicle holding commodity futures contracts. As noted above, commodity futures contracts can include instruments, such as stock index futures, normally used to hedge a securities portfolio. This includes stock index futures on foreign stock exchanges that are traded outside of the United States. However, the operator of an offshore fund that is a 'commodity pool' only by reason of investing in 'foreign futures' or 'foreign options' (ie, the fund holds no commodity futures contracts traded in the United States) need not register as a CPO if certain conditions are met. First, the fund must be located outside of the United States and be exempt from registration under the Investment Company Act, and the securities of the fund must be exempt from registration under the Securities Act. Secondly, no more than 10% of the participants in the offshore fund and no more than 10% of the value of the fund may be held by US persons.<sup>170</sup> If the operator or adviser to the pool is located outside of the United States, and if the requirement to register as a CPO or CTA arises only by reason of activities in relation to foreign



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futures or foreign options, the manager or operator may, in lieu of registration, apply for an exemption that requires the appointment of the NFA or certain other persons as agent for service of process.<sup>171</sup>

The staff of the CFTC take the position that offering and selling to a US person an interest in an offshore fund that invests in foreign futures or foreign options (irrespective of the amount of such investments) is, for regulatory purposes, the same as directly offering and selling to such person any foreign futures or foreign options contract that the offshore fund invests in, regardless of the level of US participation in the offshore fund. Accordingly, the staff take the position that an offshore fund with US participants must purchase all its foreign futures or foreign options contracts through a US-registered commodities futures merchant or through a foreign commodities futures merchant that is exempt from registration pursuant to 17 C.F.R. § 30.10.<sup>172</sup> Moreover, the fund may not purchase foreign stock index futures contracts or foreign futures contracts or options on foreign government debt obligations other than those that have been approved for sale directly to US persons.<sup>173</sup> Given the reality of the intervening entity of the offshore fund between the foreign futures and options contracts and the US participants in the foreign fund, it is difficult to support this interpretation on a legal basis, provided that the fund is not being used as an artifice to avoid the requirements that would apply if the foreign futures or foreign options contracts were indeed being offered directly to the US participants in the offshore fund.

The staff of the CFTC have also adopted an analogous policy relating to funds that invest in commodities pools. An interest in a commodities pool is deemed to be tantamount to an interest in the commodities futures contracts held by that pool. Thus, the staff's position is that the operator of and adviser to a fund of funds must register as a CPO and CTA, respectively. It is difficult to see the legal basis for this position, since the investor fund itself will not hold any commodity futures contracts. The definitions of 'commodity pool operator' in the CEA<sup>174</sup> and of 'pool'<sup>175</sup> and 'commodity interest'<sup>176</sup> in the CFTC Regulations all refer to entities holding commodities futures contracts or other instruments regulated by the CEA. Other commentators have also noted the lack of basis in the statute for this staff position.<sup>177</sup>

### Public Offerings of Offshore Funds in the United States

The closest contact of an offshore fund to the United States, a public offering of the shares of the fund in the United States, is not a practical possibility at present. In order to make a public offering of its securities, an offshore fund must obtain an order from the SEC, which can be issued by the SEC only if it finds that, by reason of special circumstances or arrangements, it is both legally and practically feasible

effectively to enforce the provisions of the Investment Company Act against the offshore fund and that the issuance of the order is otherwise consistent with the public interest and the protection of investors.<sup>178</sup>

Over the 58 years of the Investment Company Act's history, only 19 foreign investment funds, mostly from Canada, have received orders under s. 7(d). The last such order was issued in 1973.<sup>179</sup> In a 1992 SEC staff report prepared by the SEC's Division of Investment Management entitled *Protecting Investors: A Half-Century of Investment Company Regulation* (1992 Report), the staff of the SEC noted the frustration to foreign investment companies and their managers caused by the rigid standards of s. 7(d) of the Investment Company Act.

The staff suggested in the 1992 Report that s. 7(d) be amended to make it easier for the SEC to issue orders under s. 7(d) and to grant exemptions from the requirements of the Investment Company Act to foreign funds. Under the proposed amendment, orders would be granted only to 'operating foreign investment companies', which would be defined as non-US investment companies investing primarily in securities of non-US issuers that have been operated for at least three years and have met criteria to be prescribed by the SEC to demonstrate that they are bona fide operating foreign investment companies. There has been no attempt to introduce the suggested amendment into legislation before the US Congress, despite the consideration of the NSMIA, which made other amendments to the Investment Company Act.

*\*The authors gratefully acknowledge the assistance of Natalia Cavaliere, Marc Cozzolino, Raymond Hum and Paul Jeun of the firm's Corporate/International Department and Richard Boyd and Cara Morea of the firm's Tax Department in reviewing and commenting on portions of the chapter. Any errors, however, are the responsibility of the authors.*

### Endnotes:

1. As used in this chapter, the term 'offshore fund' means a pooled investment vehicle organised under the laws of a jurisdiction outside of the United States, whether in corporate (company), partnership, trust, contractual (eg, *fonds commun de placement*) or other form. Although for certain purposes (eg, US taxation of the income of the offshore fund) the jurisdiction of the organisation may matter, for many purposes US regulatory concerns do not vary with the jurisdiction of organisation, ie, whether the jurisdiction of the organisation is highly or lightly regulated. An exception to this general rule is that US AML requirements may be more burdensome for

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offshore funds that are not organised in a member country of the Financial Action Task Force and may be particularly burdensome for offshore funds that are organised in jurisdictions considered to be 'countries of primary money laundering concern', which are to be defined in regulations to be adopted under s. 311 of the PATRIOT Act.

2. As used in this chapter, the term 'United States' means the United States of America, its territories and possessions.

3. As used in this chapter, the term 'shares of an offshore fund' means legally enforceable equity interests in an offshore fund, regardless of the form of the offshore fund.

4. Notable exceptions to this general rule would arise when a foreign investor, such as an offshore fund, invests in certain sensitive US industries, such as certain defence industries, telecommunications, commercial aviation, certain energy resource industries, and US flag-shipping operations. See also specific matters covered in the first section of this chapter entitled *Limited Contact with the United States — Investment and Custody*. In addition, custody of assets in the United States, and even maintaining monetary assets in US dollars, may have US regulatory implications when the offshore fund invests in, or as some US legislation terms it, 'traffics' in, assets of, or trades with, foreign enemies of the United States. See, eg, the International Emergency Economic Powers Act, 50 USC. § 1701–1706; the Trading with the Enemy Act, 50 App USC. § 1 *et seq.*; and the Cuban Liberty and Democratic Society Solidarity (LIBERTAD) Act of 1996, 22 USC. § 6021–6091, the Cuba Democracy Act, 22 USC § 6001 *et seq.* Maintenance of assets at a US-regulated financial institution may also expose the foreign investor to US AML Laws. A generalised treatment of these matters, which are common to all non-US investors, and not just offshore funds, is outside the scope of this chapter.

5. A significant exception to this general statement arises if the offshore fund invests in US real property interests, in US operating entities that are characterised as partnerships for US tax purposes or in US corporations, a significant portion of the assets of which consist of US real property interests. See p.121. In addition, an offshore fund in partnership form that has US-source income is required to file a US return with the IRS.

6. 15 USC. § 78a *et seq.*

7. Institutional investment managers are allowed to rely on a list of securities published by the SEC in Rule 13f(1) (17 C.F.R. § 230.13f-1).

8. 7 USC. § 3501 *et seq.*

9. 17 C.F.R. §§ 15.01–15.05.

10. 17 C.F.R. §§ 18.01–18.06.

11. 17 C.F.R. § 18.04.

12. 15 USC. § 80 a-1, *et seq.*

13. The 3(c)(1) and 3(c)(7) exclusions from the definition of 'investment company' are more fully discussed in the section on the Investment Company Act, under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.

14. See the section on the Investment Company Act, under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.

15. NASD Conduct Rules, Interpretation IM-2110-1.

16. There are certain limited exceptions to the restrictions if the NASD member can demonstrate that the sales of the hot issues were within the restricted persons' normal securities purchasing habits.

17. See paragraphs (b)(2)-(b)(9) of the Interpretation.

18. Sales to US-registered investment companies are not prohibited.

19. See paragraph (f) of the Interpretation.

20. See paragraph (l)(6) of the Interpretation.

21. The NASD has proposed replacing the Interpretation with a formal rule, Proposed Rule 2790 (the Proposed Rule). In June 2002, the NASD submitted Amendment No. 4 to the Proposed Rule to the SEC for comment and/or adoption. In many respects, the Proposed Rule codifies the Interpretation.

Under the Proposed Rule, the general prohibitions do not apply to sales to and purchases by foreign investment companies that: (i) are listed on a foreign exchange or authorised for sale to the public by a foreign regulatory authority; and (ii) in which no person owning more than 5% of the shares is a restricted person. Thus, the Proposed Rule eliminates some of the prior conditions for the foreign investment company exemption under the Interpretation.

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Moreover, the Proposed Rule streamlines certain of the preconditions for sale. Before selling a new issue to any account, an NASD member must in good faith have obtained within 12 months prior to such sale, a representation from:

(1) beneficial owners — the account holder(s), or a person authorised to represent the beneficial owners of the account, that the account is eligible to purchase new issues in compliance with the rule; or

(2) conduits — a bank, foreign bank, broker-dealer, or investment adviser, or other conduit that all purchases of new issues are in compliance with this rule.

A member may not rely upon any representation that it believes, or has reason to believe, is inaccurate. The member must maintain a copy of all records and information relating to whether an account is eligible to purchase new issues in its files for at least three years following the member's last sale of a new issue to that account.

22. US Internal Revenue Code of 1986, as amended (the Code), § 864(b).
23. That is, entities in the United States that are not treated as partnerships for US income tax purposes. 'Limited liability companies' incorporated under state law are generally treated as partnerships for US income tax purposes.
24. For additional considerations regarding how an offshore fund would be taxed on its effectively connected income, see the section entitled *Tax Implications to the Offshore Fund of Having a US Investment Manager/Sponsor* in this chapter.
25. This would include the federal corporate income tax which currently has as its highest marginal rate 35%, and the federal branch profits tax which is imposed at a rate of 30%, unless reduced by an applicable income tax treaty. In addition, there would probably be state and local taxes that would be imposed on income effectively connected to a US trade or business.
26. Whether or not an offshore fund in partnership form has effectively connected income, non-US investors in the fund who hold their interest in their individual names will be exposed to US estate taxation on their portion of the US assets of the fund in the event of their death.
27. 26 USC. § 1 *et seq.*

28. Code § 871(h)(2) provides that portfolio interest is interest paid on two types of obligations: (i) bearer obligations described in Code § 163(f)(2)(B); and (ii) registered obligations with respect to which the US person has received a statement that the beneficial owner of the obligation is not a US person. Many types of debt instruments can be structured to be instruments generating portfolio interest.
29. Pursuant to § 871(h), to qualify as portfolio interest, the interest on a debt obligation must not be paid to a '10% shareholder'. In the case of a debt obligation issued by a corporation, a '10% shareholder' means any person who owns 10% or more of the total combined voting power of all classes of shares of the corporation. If an offshore fund is in partnership form, the fund's direct holdings will be aggregated with those of its partners that are co-investing with the partnership in the same corporate issuer. Where a corporate obligation is held by an intervening partnership, such as a US venture capital partnership in which the offshore fund invests, the issue arises whether a 10% ownership determination is made at the level of the partnership or at the level of the partners of the partnership. In the instance of a partnership which holds more than 10% of the shares of the US issuer of the debt, if the 10% determination is made at the partnership level, the interest on the debt obligation accruing to the offshore fund would not qualify as portfolio interest. In contrast, if the 10% ownership determination is made at the partner level, the interest may qualify as portfolio interest. Although no rule or regulation provides guidance with regard to a proper determination of the ownership requirement, many practitioners make determinations of the 10% ownership at the partner level.
30. The double taxation treaties generally reduce the rate of withholding to 15% (or in some cases to 5%) on dividends, and to 15% or 10% on interest. Also, some treaties reduce the withholding rate on dividends to 5% when the recipient fund holds a substantial portion of the equity in the issuer of the dividend. For example, Article X(2) of the double tax treaty between the United States and Sweden requires that the recipient hold at least 10% of the voting stock of the US payor of the dividend to have the benefit of the 5% withholding rate.
31. Many garden-variety offshore corporate forms commonly used for offshore funds, including Cayman Islands exempted companies, British Virgin Island international business Corporations and Netherlands Antilles NVs, can elect to be treated as partnerships for US tax purposes under the so-called check-the-box regulations issued by the IRS (§ 301.7701-3).

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Offshore funds should be wary of electing to be treated as partnerships for US tax purposes. An offshore fund in partnership form that has US-source income is required to file a US return. In addition, under revised withholding regulations as they relate to offshore partnerships, the individual 'partners' (equity holders) in the partnership would be required to file individual declarations of foreign status in order to avoid more onerous US withholding on gross proceeds of securities transactions. Finally, an offshore fund electing to be treated as a partnership for US tax purposes exposes its non-US investors who hold an interest in the fund in their individual names to US estate taxation on their portion of the fund's US assets.

32. In addition, a US corporation is not considered a United States real property holding corporation by reason of its previous ownership of real property if all such real property interests were disposed of in a transaction in which gain was or would have been recognised.
33. Special concerns arise when sales activities take place from locations within the United States. See below.
34. 17 C.F.R. § 230.901–904.
35. 15 USC. §§ 77a–77z, 77aa.
36. The registration provisions of the Securities Act technically apply only if the US interstate means of commerce (eg, mails, telephone, etc) are used in connection with the offering. However, many offshore funds take care to structure their non-US offerings to achieve the Regulation S safe harbour even if they are not simultaneously offering in the United States and no use of the US interstate means of commerce is apparent in their non-US offers.
37. A 'safe harbour' exemption is a rule setting forth specific conditions that, if met, will assure that a general statutory provision will or will not be applicable.
38. A 'foreign issuer' as defined in Regulation S that is not a 'foreign government'.
39. Substantial US market interest is defined in relation to the trading volume in shares of the issuer on US securities markets in relation to trading volume in shares of the issuer on securities markets outside of the United States.
40. Generally, any publication that is printed primarily for distribution in the United States or that has had, during the preceding 12 months, an average circulation within the United States of 15,000 copies or more per issue. Some international publications have specialised 'US editions'. In those cases, only the US edition of the publication will be considered a publication with a general circulation within the United States, provided that, in the absence of the US edition, the publication as a whole would not have 15,000 average circulation within the United States and the US edition meets the definition of a publication with a general circulation in the United States.
41. See the section entitled *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.
42. Generally speaking, s. 5 of the Securities Act prohibits the use of the US interstate means of commerce in connection with the offer or sale of securities unless a registration statement in accordance with s. 6 of the Securities Act with respect to the transaction has been filed with the SEC and the staff of the SEC has declared the registration statement effective. There are, however, certain exemptions to these registration requirements under the Securities Act, which are of use to offshore funds. See the section on Internet sales in this chapter.
43. Engaging in the business of effecting transactions in securities for the account of others.
44. § 29(b) of the Exchange Act.
45. Almost any communication that is intended to or has the effect of inducing the purchase of a security would be considered an 'offer' for securities law purposes, even if it is not an offer for contract law purposes.
46. If the offer is considered to be made to persons in the United States, it is likely that no exemption would be available, since, in the absence of special passwording systems, the information would be available to any person with Internet access and thus would be a public offer. In the case of an offshore fund, this would lead to violation of not only the Securities Act but also the Investment Company Act.
47. Release 33-7516.
48. See the section on the Investment Company Act, under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.



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- <sup>49.</sup> See, generally, the section entitled *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.
- <sup>50.</sup> Publicly available 26 July 1996.
- <sup>51.</sup> Lamp Technologies I, publicly available 29 May 1997. Lamp Technologies II, publicly available 29 May 1998.
- <sup>52.</sup> Note 30.
- <sup>53.</sup> See Lamp Technologies and Thomson Financial Inc., publicly available 10 July 2002.
- <sup>54.</sup> In Thomson Financial Inc., the website at issue provided information about private investment funds such as the names, phone numbers, fax numbers and e-mail addresses of portfolio managers, analysts and traders; manager biographical data; and firm profile data such as the year a fund started, total assets, investment philosophy, industry focus, market focus, securities selection strategy and breakdown of assets.
- <sup>55.</sup> Pub. L. No. 107-56 (2001).
- <sup>56.</sup> 31 U.S.C. 5311 *et seq.*
- <sup>57.</sup> Covered financial institutions are required to establish an anti-money laundering programme that includes, at a minimum: (i) development of internal policies, procedures, and controls; (ii) the designation of a compliance officer; (iii) an ongoing employee training programme; and (iv) an independent audit function to test the programme.
- <sup>58.</sup> 67 FR 21117 (29 April 2002).
- <sup>59.</sup> Notice of Proposed Rulemaking, Financial Crimes Enforcement Network: Anti-Money Laundering Programs for Unregistered Investment Companies (26 September 2002).
- <sup>60.</sup> As defined in Regulation S.
- <sup>61.</sup> Section 326 of the PATRIOT Act (codified at 31 USC. 5318)(2001)).
- <sup>62.</sup> 15 USC. § 80b-1 *et seq.*
- <sup>63.</sup> A US-based adviser is exempt from registration if it has fewer than 15 clients in any 12-month period, does not hold itself out to the public as an investment adviser, and does not advise a registered investment company or a business development company.
- <sup>64.</sup> Normal sales activities in connection with the offshore fund where the investment manager is not separately compensated should not be considered advice to the individual partner.
- <sup>65.</sup> Rule 203(b)(3)-1 under the Advisers Act.
- <sup>66.</sup> This is unlike the situation of a non-US-based investment adviser that is registered under the Advisers Act. In accordance with the 'conduct and effects' test now applied by the SEC, a non-US-based investment adviser is, in most respects, able to treat its non-US clients in accordance with the rules and standards applicable in its home jurisdiction rather than US rules and standards, provided certain procedures are followed. See, eg, *National Mutual Group* (publicly available 8 March 1993); *Murray Johnstone International Ltd* (publicly available 7 October 1994).
- <sup>67.</sup> H.R. 3005, 104th Cong., 2d Sess. (1996) (codified in various sections of 15 USC.).
- <sup>68.</sup> Section 205 of the Advisers Act generally prohibits registered advisers from charging fees based on 'compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client'. Such fees, generally referred to as 'performance fees' or 'incentive fees', are a normal and important part of compensation of investment advisers by institutional accounts. The general prohibition of Section 205 forced registered advisers to use one of two approved exceptions to the rule. One such exception is contained in S. 205(b)(2)(B) of the Advisers Act and allows fees that increase or decrease proportionately with the investment performance of the assets in comparison to the investment record of an appropriate index of securities prices. The second, and more commonly used exception, is that set forth in Rule 205-3 under the Advisers Act, which provides flexibility in structuring a performance fee provided that, *inter alia*, the client in question meets certain requirements. Generally speaking, those requirements are that the client be a natural person or company (not including a private investment company) committing at least US\$750,000 to the management of the investment adviser or having a net worth of at least US\$1.5 million. In the case of a private investment company, the minimum investment or net worth requirements apply to the shareholders of the private investment company. Prior to the NSMIA, US-registered investment advisers that charge performance fees to offshore funds generally have relied on this latter exception to the performance fee prohibition of s. 205.

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- <sup>69.</sup> Non-US-based investment advisers that are registered under the Advisers Act are not required to follow most US rules, including the performance fee proscription, with respect to their non-US clients.
- <sup>70.</sup> See *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter for allowable levels of US ownership in offshore funds.
- <sup>71.</sup> Publicly available 14 March 1990.
- <sup>72.</sup> Section 208(d) of the Advisers Act provides that it is unlawful for any person indirectly, or through or by any other person, to do any act or thing which it would be unlawful for such person to do directly under the provisions of the Advisers Act or any regulation thereunder.
- <sup>73.</sup> The brochure must be provided not less than 48 hours before entering into an advisory contract or not later than the time that the contract is concluded if the client has a five-day grace period to terminate the contract. The adviser is also required annually to deliver, or offer to deliver, the brochure to all of its clients.
- <sup>74.</sup> Rule 206(4)-3 under the Advisers Act.
- <sup>75.</sup> This interpretation has been adopted by the staff of the SEC in a no-action letter, *Stein, Roe & Farnham* (publicly available 29 June 1990). The staff's interpretation is that soliciting an investor in a fund managed by a registered investment adviser is 'indirectly' soliciting a client for the registered investment adviser. The inconsistency of this interpretation with other regulations that define who is the client of the investment adviser for other purposes (see, eg, Advisers Act, Rule 203(b)(3)-1) did not seem to concern the staff. See also *Dechert Price & Rhoads* (publicly available 4 December 1990).
- <sup>76.</sup> 7 USC. §§ 1 *et seq.* (1980).
- <sup>77.</sup> See Part 30 of regulations adopted by the Commodity Futures Trading Commission (17 C.F.R. 30.1 ff).
- <sup>78.</sup> Or if there are US investors in the fund, as to which see the section on the *Implications of US Sales for Offshore Funds that are Commodity Pools*, under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.
- <sup>79.</sup> Fifteen or fewer clients in any 12-month period (CEA § 4m; 7 USC. § 4m).
- <sup>80.</sup> CFTC Interpretive Letter 75-17. This is in marked distinction to the position of the SEC with respect to looking through a fund to count clients for the purposes of the *de minimus* exemption from registration under the Advisers Act.
- <sup>81.</sup> CFTC Regulation 4.22 (17 C.F.R. § 4.22).
- <sup>82.</sup> CFTC Regulation 4.24 (17 C.F.R. § 4.24).
- <sup>83.</sup> CFTC Regulation 4.23 (17 C.F.R. § 4.23).
- <sup>84.</sup> Even if the fund did not become directly subject to the new AML requirements by reason of hiring such a US investment manager (on the basis that the mere manager of a portion of the fund's assets does not organise, operate or sponsor the fund), hiring such a US investment manager would indirectly expose the fund to additional AML burdens, since, although US investment advisers are not currently financial institutions covered by the amended BSA requirements, they are expected to be added to the list of covered financial institutions in the near future.
- <sup>85.</sup> Such notice filings, while unlikely to be public documents, would provide an interesting, previously uncollected database of offshore funds with the requisite contacts with the United States.
- <sup>86.</sup> See text accompanying endnote 471.
- <sup>87.</sup> Until 1 January 1997, a determination of whether an offshore fund would be treated as a partnership for US tax purposes depended upon a four-factor test to determine whether the entity was more like a partnership or more like a corporation. It also required certain structuring features, such as a general partner receiving a set minimum portion of gains and losses in the fund, in order to secure treatment as a partnership. However, effective 1 January 1997, the United States adopted the so-called check-the-box rules for partnership characterisation (see endnote 29), which provide that certain types of entities will be considered partnerships without any action and certain other enumerated types of entities may make simple elections to assure their treatment as partnerships for US federal tax purposes.
- <sup>88.</sup> Federal rates of corporate taxation of net income range from 15% to 39%. Rates of taxation on net income by the several states of the United States vary considerably. In addition, some states of the United States seek to tax the worldwide income of a foreign corporation that does business within the state.

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- <sup>89.</sup> Section 884(b) of the Code generally defines the 'dividend equivalent amount' as the foreign corporation's effectively connected earnings and profits for the taxable year, increased by the decrease in US net equity and decreased by the increase in US net equity in a taxable year.
- <sup>90.</sup> Depending upon the status of tax treaties between the United States and the home country of the investor and the tax laws of the home country, the foreign investor may be able to obtain a credit against home country taxes for taxes paid in the United States.
- <sup>91.</sup> Ordinarily, an individual or institutional foreign investor would not be taxed in the United States on capital gains realised on the purchase and sale of US securities.
- <sup>92.</sup> Other authority extended the s. 864(b)(2) safe harbour concept to foreign partnerships (Reg. 1.864-2(c)). However, most practitioners consider that a partnership can have its principal office only at the office of one of its general partners. Prior to August 1997, most offshore funds in partnership form that sought the s. 864(b)(2) safe harbour had an offshore general partner responsible for administrative matters.
- <sup>93.</sup> P.L. 105-34 (5 August 1997).
- <sup>94.</sup> Those 10 functions were: (1) communicating with shareholders (including the furnishing of financial reports); (2) communicating with the general public; (3) soliciting sales of its shares; (4) accepting subscriptions from new investors; (5) maintaining its principal corporate records and books of account; (6) auditing the books of account; (7) disbursing dividends, legal fees, accounting fees, and officers' and directors' salaries; (8) publishing and furnishing the offering and redemption prices of its shares; (9) conducting meetings of its shareholders and directors; and (10) making redemptions of its shares.
- <sup>95.</sup> For example, the SEC has concluded numerous Memoranda of Understanding with foreign securities regulators that provide for mutual assistance in the gathering and exchange of information in certain circumstances.
- <sup>96.</sup> This has been particularly frequent in the case of Canadian investors in Canadian investment funds who later retire to the warmer climes of the southern parts of the United States. See, however, discussion in endnotes 161–163 which relate to the section entitled *Public Offerings of Offshore Funds in the United States*, in this chapter and which covers special provisions relating to offers to Canadian citizens resident in the United States. Also, sales of offshore funds to US expatriates can generally be undertaken without concern for US securities laws, as long as such funds are not targeted at identifiable groups of US expatriates, such as armed service personnel or US expatriates that are about to return to the United States.
- <sup>97.</sup> Publicly available 27 August 1984. A 'no-action' letter is an interpretive letter issued by the staff of the SEC indicating that if the applicant for the no-action letter undertakes a course of conduct (explicitly defined in the request for the no-action letter) in accordance with the opinion of its legal counsel that such conduct does not violate US federal securities laws, the staff of the SEC will not recommend that the SEC take enforcement action against the applicant for undertaking such conduct. No-action letters are binding relief only for their recipients, but are often viewed as indications of the attitudes of the staff of the SEC as to enforcement and interpretative matters and are often relied on by other securities industry participants who propose to undertake conduct substantially the same as that for which previous no-action letters have been granted.
- <sup>98.</sup> See § 3(a) of the Investment Company Act.
- <sup>99.</sup> See the section on *Public Offerings of Offshore Funds in the United States* in this chapter.
- <sup>100.</sup> For the purposes of the Investment Company Act, the term 'public offering' generally takes on the same meaning as under the Securities Act.
- <sup>101.</sup> Section 3(c)(1) of the Investment Company Act. Amendments to the Investment Company Act in 1996 added s.n 3(c)(7) to the Investment Company Act, which allows US investment funds to have more than 100 shareholders without registering under the Investment Company Act, as long as their shares are sold in a private offering only to certain 'qualified purchasers'. See the section on the Investment Company Act under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.
- <sup>102.</sup> See the section on the Investment Company Act under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter, for a discussion of the meaning of 'US shareholder' for this purpose.
- <sup>103.</sup> Many commentators have noted that the position taken by the staff of the SEC in the *Touche Remnant* letter as regards their interpretation of s. 7(d) of the Investment Company Act is not on firm legal ground. In 1990, the SEC itself adopted its staff's

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interpretation by noting with favour the *Touche Remnant* no-action letter in the adopting release for Rule 144A under the Securities Act. In the *Goodwin, Proctor and Hoar* no-action letter, the SEC sought to rationalise its legal sleight-of-hand in combining the s. 7(d) and s. 3(c)(1) standards, by asserting that when the US Congress passed the Investment Company Act in 1940, the term 'private placement' had a very limited meaning and under no circumstances could Congress have envisioned a private placement to more than 100 persons. It is difficult to see how an enforcement action based solely on a violation of the registration requirements of s. 7(d), as interpreted by the staff of the SEC in the *Touche Remnant* no-action letter, could be upheld by a court, but it is unlikely that any offshore fund operator would choose to dispute the SEC on the point outside of the defence of an enforcement action also based on other violations. No attempt was made to incorporate the *Touche Remnant* interpretation of s. 7(d) at the time of the amendments to other portions of the Investment Company Act in the NSMIA.

<sup>104</sup>. See the section on the Investment Company Act under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.

<sup>105</sup>. See *Global Mutual Fund Survey* no-action letter, publicly available 14 July 1992.

<sup>106</sup>. Publicly available 4 March 1996.

<sup>107</sup>. The conditions are as follows:

- (1) the fund has not publicly offered or sold its securities in the United States;
- (2) the fund and its agents or affiliates have not engaged in activities that could reasonably be expected, or are intended, to condition the US market with respect to the fund's securities, such as placing an advertisement in a US publication;
- (3) the fund and its agent or affiliates have not engaged in activities that could reasonably be expected, or are intended, to facilitate secondary market trading in the United States with respect to the fund's securities;
- (4) the fund and its agents or affiliates have not knowingly engaged in a deliberate marketing strategy, adopted directly by the fund's manager or other entity responsible for the business and affairs of the fund, that is calculated to result in the sale of securities to foreign investors who are relocating to the United States;
- (5) the 100 US investor limit is exceeded solely because non-US holders (ie, beneficial owners who purchased their securities while residing outside the United States) have relocated to the United States (US

residents that make offshore secondary market purchases of securities of the fund in circumstances in which the secondary purchase occurs without the direct or indirect involvement of the investment company, its affiliates, agent or intermediaries, would be considered to be non-US holders); and

- (6) the fund's activities with respect to non-US holders of its shares are limited to providing the following services: (a) the mailing of security holder reports, account statements, proxy statements and other materials that are required to be provided by foreign law and the fund's governing documents; (b) the processing of redemption requests and payment of dividends and distributions; (c) the mechanical processing of transfers of ownership; and (d) the issuance of securities pursuant to a dividend reinvestment plan.

<sup>108</sup>. To the extent that such tender offers also give rise to special exercise rights of outstanding warrants, they may also constitute offers of securities giving rise to Securities Act registration concerns.

<sup>109</sup>. For this purpose, the term 'business day' means any day, other than Saturday, Sunday or a US federal holiday, and consists of the time period from 12:01 am through midnight Eastern Standard Time. In computing any time period for the purposes of the tender offer rules, the date of the event that begins the running of such time period is included, except that if such event occurs on other than a business day, the period begins to run on and includes the first business day thereafter.

<sup>110</sup>. It should be noted that acceptance of payment of an additional amount of securities, not to exceed 2% of the class of securities that is the subject of the tender offer will not be termed as an increase.

<sup>111</sup>. Rule 14e-5 is subject to various limited exceptions.

<sup>112</sup>. Instruction 2 of Rule 14d-1 sets forth the formula to calculate the percentage of US persons' ownership interest of the fund for the purposes of the Tier I Exception. As an initial matter, the instruction requires that the calculation of US ownership occur 30 days prior to the commencement of the tender offer. When calculating the percentage of a shareholder's interest, warrants, options and convertible securities must be included. However, as discussed above, securities held by persons who hold more than 10% of the subject securities are not to be included in the calculation. Moreover, securities held by a bidder should also be excluded. In order to calculate the percentage of securities a shareholder holds, it is necessary to establish record ownership of the



outstanding securities. A record owner is the person who is identified as the owner of such securities on records of security holders maintained by the issuer. Instruction 2 sets forth the following as additional guidance to determine record ownership of the securities: (i) in instances where the records of security holders have not been properly maintained, any person who would have been viewed as a record owner if the records were properly maintained, will be included as a holder of record for the purposes of the calculation; (ii) securities held by a corporation, partnership or trust, or other organisation shall be included as held by one person in the calculation; (iii) securities held by co-owners shall be included as being held by one person in the calculation; (iv) securities held by trustees, executors, guardians, or other fiduciaries for a single estate, trust or account, shall be included as if held by one person for the calculation; (v) each outstanding unregistered or bearer certificate shall be included as held by a separate person, unless clearly established otherwise for the purposes of the calculation; (vi) if reason exists to believe that securities registered to persons with similar names are in fact meant to be registered to the same person, such securities shall be viewed as held by one person; and (vii) securities held subject to a voting trust or similar arrangement shall be included as held of record by the number of record holders of the voting trust.

- <sup>113</sup>. The offeror must make reasonable enquiries to the banks and nominees to obtain information about separate customer accounts. The issuer must attempt to ascertain the aggregate amount of the nominee's holdings that are represented by US accounts for the purpose of calculating US ownership under the Tier I Exception. The issuer may also determine ownership of such accounts based on reports provided to the issuer or publicly filed reports in the United States or in the home jurisdiction of the fund, as well as ownership information that is otherwise provided to the issuer of the offeror.
- <sup>114</sup>. Failure to comply with the requirements for the safe harbour exemption does not necessarily preclude the availability of the statutory exemption.
- <sup>115</sup>. 17 C.F.R. §§ 230.501–508.
- <sup>116</sup>. Some offshore funds purport to make 'Rule 144A' offerings in the United States. This is something of a misnomer, as Rule 144A under the Securities Act provides a safe harbour for resales of securities rather than initial issuances. Transactions labelled as Rule 144A placements are typically combination transactions involving the initial sale of shares by the

offshore fund to a distributor in a transaction exempt from Securities Act registration by reason of s. 4(2) or Regulation S. The distributor then resells to US institutional investors, often in 'riskless principal' transactions under Rule 144A. Such transactions deprive the offshore fund of a significant portion of the US market that they may otherwise wish to sell to. Only 'qualified institutional buyers' may purchase in a Rule 144A placement. The offshore fund may wish to sell to 'accredited investors' (if the fund is relying on s. 3(c)(1) of the Investment Company Act) or 'accredited investors' who are also 'qualified purchasers' (if the fund is relying on s. 3(c)(7) of the Investment Company Act). See the section on the Investment Company Act under *Non-public Offerings of Shares of an Offshore Fund in the United States* in this chapter.

- <sup>117</sup>. A leading case in the private placement area continues to be the general treatment in *SEC v. Ralston Purina Co.* 346 US 119 (1953).
- <sup>118</sup>. That is, without public advertising or other means of general solicitation. See the discussion of Regulation D.
- <sup>119</sup>. Full compliance with Regulation D also requires the filing with the SEC of Form D within 15 days after the first sale of securities pursuant to the exemption. Form D is a relatively simple filing. In the past, some offshore funds, especially those that have made relatively limited solicitations only of US institutional investors, have chosen to comply with all portions of Regulation D other than the filing of Form D, taking the position that they are then likely entitled to the statutory s. 4(2) exemption. In view of the benefits of full compliance with Regulation D for state securities law compliance, as noted below, most offshore funds will now proceed with filing Form D.
- <sup>120</sup>. An accredited investor is any of the following: (i) an individual with a current income in excess of US\$200,000 or joint income with his or her spouse in excess of US\$300,000, and who reasonably expects to reach at least the same level of income in the current year, or has a net worth, either individually or together with his or her spouse, in excess of US\$1 million; (ii) a bank, as defined in the Securities Act, or a savings and loan association or other institution as defined in the Securities Act, whether or not acting in its individual or fiduciary capacity; (iii) a broker or dealer registered pursuant to the Exchange Act; (iv) an insurance company as defined in the Securities Act; (v) an investment company registered under the Investment Company Act or a business development company as defined in that Act; (vi) a small business

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investment company licensed by the US Small Business Administration under the Small Business Investment Act of 1958; (vii) a plan established and maintained by a state or any of its political subdivisions, or any agency or instrumentality of a state or any of its political subdivisions, for the benefit of its employees and has total assets in excess of US\$5 million; (viii) an employee benefit plan within the meaning of ERISA and the purchase of the investment is being directed by a plan fiduciary as defined in ERISA, which is either a bank, a savings and loan association, an insurance company or a registered investment adviser; or such plan has total assets in excess of US\$5 million or is a self-directed plan, and the purchase of the investment is being directed by persons that are 'accredited investors'; (ix) a private business development company as defined in the Advisers Act; (x) a corporation, a Massachusetts or similar business trust, a partnership or a charitable organisation described in s. 501(c)(3) of the Code, which was not formed for the purpose of acquiring the investment and has total assets in excess of US\$5 million; (xi) a trust, which was not formed for the purpose of acquiring the investment, which has total assets in excess of US\$5 million and the purchase of the investment is being directed by a person who is either an 'accredited investor' or, if not an accredited investor, has such knowledge and experience in financial and business matters that he or she is capable of evaluating the merits and risks of an investment in the investment; or (xii) an entity in which all of the equity owners are 'accredited investors'.

<sup>121.</sup> Section 10(b) of the Exchange Act and Rule 10b-5 thereunder.

<sup>122.</sup> See, eg, *E.F. Hutton & Co. Inc. and Bateman Eichler, Hill Richards, Inc.* (both publicly available 3 December 1985). However, in its discussion of *IPONET* in Use of Electronic Media (Release No. 33-7856), the SEC noted that, generally, SEC staff interpretations of whether a 'pre-existing, substantive relationship' exists have been limited to procedures established by broker-dealers in connection with their customers. The SEC stated that this is because traditional broker-dealer relationships require that a broker-dealer deal fairly with, and make suitable recommendations to, customers, and, thus, implies that a substantive relationship exists between the broker-dealer and its customers. The SEC then went on to state that it did *not* view the SEC staff responses to *Lamp Technologies* (where, in contrast to *IPONET*, the intermediary was *not* affiliated with a broker-dealer) as extending the 'pre-existing, substantive relationship'

doctrine to solicitations conducted by third parties other than a registered broker-dealer. Rather, the SEC staff in *Lamp Technologies* 'recognised a separate means to satisfy the 'no general solicitation' requirement solely in the context of offerings by private hedge funds that are excluded from regulation as investment companies'. This language raises the question of whether the SEC now views the pre-existing substantive relationship as an essential element of 'no general solicitation' in the context of direct offers by the issuer itself, ie, that involve no broker-dealers.

<sup>123.</sup> If the shares are uncertificated, the registrar is given a list of the US shareholders whose shares are subject to the restrictions on transfer.

<sup>124.</sup> This is the so-called s. 4(1-1/2) exemption, so named because it has elements of both an ordinary re-sale of unrestricted securities by a person who is not an issuer, underwriter or dealer (the exemption provided by s. 4(1)) and a private placement exempt under s. 4(2).

<sup>125.</sup> 17 C.F.R. ss. 901–904.

<sup>126.</sup> One of the exchanges listed in 17 C.F.R. § 902(a)(1) or another exchange designated by the SEC in accordance with the procedures set forth in § 902(a)(2).

<sup>127.</sup> 17 C.F.R. § 144A.

<sup>128.</sup> As defined at 17 C.F.R. § 144A(a)(1).

<sup>129.</sup> The holder of the shares of the offshore fund and a prospective purchaser designated by the holder must have the right to obtain from the offshore fund, upon request of the holder, and the prospective purchaser must have received at, or prior to the time of, the resale, the following information, which must be reasonably current in relation to the date of resale: a very brief statement of the nature of the business of the issuer and the products and services it offers; and the issuer's most recent balance sheet and profit and loss and retained earnings statements, and similar financial statements for such part of the two preceding fiscal years as the issuer has been in operation. The financial statements should be audited to the extent reasonably available.

<sup>130.</sup> Such state securities laws are often referred to as 'blue sky laws'.

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- <sup>131.</sup> Or at least the number of US purchasers in the private offering. See the discussion of the *IFIC* no-action letter in the section entitled *Investment Company Act Issues* (under *US Shareholders Other Than from Offerings in the United States*) in this chapter.
- <sup>132.</sup> For the purposes of determining the number of beneficial owners, certain 'knowledgeable employees' of the manager of the fund as defined in SEC Regulation 3c-5 are not considered, nor are companies owned exclusively by knowledgeable employees or certain transferees of such knowledgeable employees. See Rule 3c-6 under the Investment Company Act.
- <sup>133.</sup> Many offshore funds limit the number of US holders to a lower number, such as 50 or 75, for safety purposes.
- <sup>134.</sup> Publicly available 28 February 1997.
- <sup>135.</sup> In generally endorsing the Regulation S definition of US person, the staff of the SEC noted that certain persons (eg, offshore companies formed by US institutional accredited investors and discretionary accounts held by non-US managers for US persons) that Regulation S excludes from the definition of US persons may nevertheless be considered US beneficial owners if the offshore fund employs such devices to reduce its US beneficial shareholder account. Such disregard of form is authorised by s. 48(a) of the Investment Company Act which prohibits a person from doing indirectly that which it would not legally be able to do directly.
- <sup>136.</sup> The fact that a transaction in the fund's shares takes place outside of the United States in a transaction within the issuer safe harbour rule of Regulation S (and thus is not subject to the registration provisions of the Securities Act) is not determinative of the question of whether the purchaser is a US beneficial shareholder that must be counted towards the 100 maximum for the purposes of s. 7(d)/3(c)(1) under the Investment Company Act. Rather, the question is whether the purchaser is a US person within the Regulation S definition.
- <sup>137.</sup> The term 'company' includes, for this purpose, a corporation, partnership, association, joint stock company, trust, fund or other organised group of persons, whether incorporated or not.
- <sup>138.</sup> Offshore funds with an incipient s. 7(d) problem normally obtain representations from their investors that they have not been formed or recapitalised for the purpose of making the investment in the offshore fund. In order to conform with certain no-action letters, the representation that the company is not 'formed for the purpose' is often buttressed by a further representation that the investment in the fund does not constitute more than 40% of the company's assets, although there appears to be no requirement for this in the statute, regulations or case law. A further way in which a company can be considered more than one beneficial owner is if the shareholders in the company have discretion as to whether they will participate in a particular investment of the company and the normal set of subscription representations also covers this rather unlikely possibility.
- <sup>139.</sup> For the purposes of determining whether all securities of the company are owned by qualified purchasers, certain 'knowledgeable employees' of the manager of the fund as defined in SEC Regulation 3c-5 are not considered, nor are companies owned exclusively by knowledgeable employees or certain transferees of such knowledgeable employees. See SEC Regulation 3c-6.
- <sup>140.</sup> The full definition is set forth in s. 2(a)51 of the Investment Company Act, as supplemented by regulations adopted by the SEC at 17 C.F.R. § 270.2a51-1.
- <sup>141.</sup> Meeting the requirements of § 2(a)(51)(A)(i) of the Investment Company Act.
- <sup>142.</sup> The SEC has adopted regulations that define 'investments' for this purpose. The definition includes: (i) securities, other than securities issued by a company affiliated with the investor, unless the issuer of the securities is a US public company, a certain type of investment vehicle or a company with shareholders' equity of not less than US\$50 million; (ii) real estate held for investment purposes; commodity interests and physical commodities held for investment purposes; (iii) certain financial contracts entered into for investment purposes; and (iv) cash and equivalents held for investment purposes.
- <sup>143.</sup> A s. 3(c)(1) company must either: (i) have only qualified purchasers as shareholders; or (ii) not be formed for the purpose of making an investment in a specific s. 3(c)(7) company. In addition, a s. 3(c)(1) company or a s. 3(c)(7) company must, in order to be treated as a qualified purchaser, obtain the consent to be treated as such from all persons who acquired their shares prior to 30 April 1996 and all shareholders of private investment companies that acquired shares in the fund prior to 30 April 1996. See Investment Company Act s. 2(a)(51)(C) and Rule 2a51-2 under the Investment Company Act. However, in the case of a s. 3(c)(1) or s. 3(c)(7) company organised under the

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laws of a jurisdiction outside of the United States, only US persons falling into the above categories must consent to the company being treated as a qualified purchaser. See the *Goodwin Proctor* no-action letter.

<sup>144.</sup> See H.E.B. Investment and Retirement Plan (H.E. Butt Grocery Company) (publicly available 18 May 2001).

<sup>145.</sup> An offshore fund in corporate form is considered a PFIC if 75% or more of its income is passive in nature (eg, interest, dividends and capital gains) or if 50% or more of its assets are devoted to the production of passive income. Under this definition, nearly all offshore funds in corporate form will be considered PFICs. The PFIC designation was introduced in 1986 in response to perceived abuses in US investors' ability to defer their gains in offshore funds until they disposed of their shares. As such, the legislation is similar in intent to that of other jurisdictions that legislated against 'rollup' funds, eg, the UK 'offshore fund' legislation.

<sup>146.</sup> 'Long-term capital gain' is defined as gain from the sale or exchange of a capital asset held for more than one year. Long-term capital gain is taxed to individual taxpayers at favourable rates as compared to ordinary income.

<sup>147.</sup> A US investor will not be subject to the general PFIC rules with respect to shares of an offshore fund if the QEF election is in effect for all tax years in which such investor holds such shares. Where the QEF election is not in effect for all such tax years, special rules co-ordinate the QEF rules with the general PFIC rules.

<sup>148.</sup> Most US investors are required to file their US federal income tax returns on 15 March (in the case of corporations) or 15 April (in the case of individuals), unless they obtain filing extensions. Therefore, each US investor should receive the PFIC Annual Information Statement from the offshore fund by 1 March of each year, assuming an offshore fund with a calendar year end.

<sup>149.</sup> The 'ordinary earnings' of a fund for a taxable year are the excess of its earnings and profits over its net capital gain. Because a fund's expenses are taken into account in determining earnings and profits, a fund's expenses will reduce the amount of ordinary earnings taken into income by a US investor with an effective QEF election.

<sup>150.</sup> For these purposes, net capital gain is the actual net gain realised from the sale of capital assets, such as securities, held for more than one year (365 days) less

any actual net loss realised from the sale of capital assets, such as securities, held for not more than one year.

<sup>151.</sup> To perform these calculations, each security is identified and its cost and holding period calculated. For example, if securities of the same class were purchased on different dates, the securities in each purchase would have a different holding period. If some but not all of the aggregate holding were sold, the fund could choose to sell either its short-term holdings or its long-term holdings. Averaging of costs or holding periods is not allowed for the purposes of determining net capital gain, mid-term gain or adjusted net capital gain.

<sup>152.</sup> Receipt of such fees directly by the fund may also be indicative of the fund's being engaged in a trade or business in the United States if the service income is from US sources. Many US tax practitioners take the position that when such fees are paid to the general partner or associated management companies, the fund's obtaining the economic benefit of such fee income by reduction of the management fees otherwise payable to the recipients does not raise an unacceptable risk of becoming engaged in trade or business.

<sup>153.</sup> 29 USC. § 1001 *et seq.*

<sup>154.</sup> For the purposes of the Plan Asset Regulations, a publicly-offered security is a security that is, among other requirements, either: (a) part of a class of securities that is registered under s. 12(b) or s. 12(g) of the Exchange Act; or (b) sold to the plan investor as part of an offering pursuant to a registration statement declared effective pursuant to the Securities Act, if the class of such securities is registered under the Exchange Act within 120 days after the end of the issuer's fiscal year during which the offering of the securities occurred.

<sup>155.</sup> It is beyond the scope of this chapter to describe all the peculiarities of ERISA compliance for an offshore fund and its managers. It is possible that an offshore fund and its investment manager could cope with such a compliance burden. For example, management of ERISA assets normally requires that the investment manager be registered as an investment adviser under the Advisers Act. If the investment manager of a foreign fund is so registered and separately manages ERISA assets under direct mandates from ERISA plans, coping with the fund's assets being treated as ERISA plan assets would entail nothing more than dealing with the offshore fund's assets in the same manner as the investment manager treats



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its direct ERISA mandates. However, compliance with ERISA requirements can be quite burdensome, and normally an offshore fund and its sponsors and managers seek to avoid having the fund's assets considered to be assets of an ERISA investor.

- <sup>156.</sup> Some practitioners believe that the reference to 'foreign plans' in the preamble to the Plan Asset Regulations had a narrower meaning, referring to employee benefit plans referenced in s. 4(b)(4) of ERISA that are maintained outside of the United States primarily for the benefit of persons substantially all of whom are non-resident aliens. Whatever the merits of this view, the DOL has, not surprisingly, adopted the broader meaning of foreign plan, as have ERISA plans and their counsel, who seek comfort from offshore funds on the plan assets issue.
- <sup>157.</sup> US counsel to an offshore fund contemplating sales to ERISA investors will often recommend that the subscription materials for non-US investors include a question designed to elicit whether the non-US investor would be considered a benefit plan investor.
- <sup>158.</sup> Unlike the registration requirements for investment advisers, there is no statutory *de minimis* exemption from registration as a broker or dealer. Also unlike registration as an investment adviser, registration as a broker-dealer requires examination of principals and representatives and also involves minimum regulatory capital requirements. Ordinarily, registration as a broker is not a practical alternative for persons soliciting US investors for offshore funds on a sporadic basis.
- <sup>159.</sup> As set forth in § 3(a)(39) of the Exchange Act.
- <sup>160.</sup> US-registered brokers and dealers, registered investment companies or registered separate accounts, insurance companies, banks, savings and loan associations, trust companies and similar institutions and certain trusts.
- <sup>161.</sup> §§ 3(a)(7), 3(a)(9) and 3(a)(10) of the Securities Act.
- <sup>162.</sup> 17 C.F.R. § 240.15a-6.
- <sup>163.</sup> US institutional investors include investment companies registered under the Investment Company Act, as well as banks, savings and loan associations, insurance companies, employee benefit plans and charitable organisations.
- <sup>164.</sup> The Rule defines major US institutional investors to include US institutional investors that have, or have under management, total assets in excess of US\$100

million, and registered investment advisers that have total assets under management in excess of US\$100 million. In a no-action letter to *Cleary, Gottlieb, Steen & Hamilton* (9 April 1997), the SEC expanded this definition to include *any entity*, including any investment adviser (whether or not registered), that owns or controls or has under management in excess of US\$100 million (on a gross basis without deduction for liabilities) in aggregate financial assets (ie, cash, money-market instruments, securities of unaffiliated issuers, futures and options on futures, and other derivative instruments).

- <sup>165.</sup> Notwithstanding this requirement, in the *Cleary, Gottlieb* no-action letter the SEC indicated that an associated person of an offshore promoter would be permitted, without participation by a US-registered broker-dealer, to engage in oral communications from outside the United States with US institutional investors where such communications take place outside of the trading hours of the New York Stock Exchange as long as the foreign associated person does not accept orders to effect securities transactions while in the United States.
- <sup>166.</sup> A single US director may be acceptable in certain circumstances. See CFTC Interpretive Letter No. 86-7.
- <sup>167.</sup> See — eg, CFTC Interpretive Letter No. 93-75.
- <sup>168.</sup> The CFTC has carved out a narrow exception to this general statement in Interpretive Letter No. 93-52. There, the CFTC stated that the operator and adviser to an offshore fund that invested in commodities and sold a portion of its shares to US persons need not register as a CPO and CTA, respectively, in the following circumstances. No more than 5% of the fund's capital would be committed as margin and premiums at any time with respect to commodity interest contracts and such transactions would be undertaken in accordance with certain restrictions set forth in the letter. Not more than 35% of the shares of the fund would be sold in the United States and those shares would be sold in a Regulation D private placement only to investors, each of whom were accredited investors, qualified institutional buyers as defined in Rule 144A under the Securities Act and qualified eligible participants as defined in Rule 4.7 under the CEA. The investors would be primarily ERISA plans (less than 25%), investment managers and commercial banks. None of the associated persons of the fund's CPO or CTA would be subject to a statutory disqualification under s. 8a(2) or 8a(3) of the CEA. The minimum subscription to the fund would be US\$2.5 million. Informal discussions with

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the staff of the CFTC indicate that the staff are not inclined to expand on this narrow exception.

On 6 November 2002, the CFTC published an Advance Notice of Proposed Rulemaking offering for public comment proposed new rules that, if adopted in their proposed form, would make sweeping changes in the CPO registration requirements for investment managers of offshore funds that utilise commodity futures in their investment strategies. In particular, the CFTC exposed for comment proposed Rule 4.9 that derives from a proposal made to the CFTC by the Managed Funds Association (the MFA Proposal). In its current form, the proposed rule would exempt from registration as a CPO a manager of an offshore (or onshore) fund that used commodity futures in its investment strategy if:

- interests in all pools that it operates are exempt from registration under the Securities Act and such interests are offered and sold without marketing to the public in the United States;
- it reasonably believes that at the time of investment, all individual investors in all pools that it operates are qualified eligible persons;
- it reasonably believes that at the time of investment, all entity investors in all pools that it operates are: (i) accredited investors; or (ii) qualified eligible persons; and
- neither the CPO nor any of its principals are subject to certain statutory disqualifications under the CEA.

Notwithstanding the exemption, a CPO would still be subject to the anti-fraud and anti-manipulation provisions of the CEA and be required, within 180 days of the end of its fiscal year, to provide participants with year-end financial statements certified by independent public accountants and prepared in accordance with generally accepted accounting principles. In addition, the CPO would be required to file two copies of the year-end financial statements with the CFTC.

Pending taking action on the proposed rules, the CFTC has determined that it will provide interim no-action relief to certain persons who would otherwise be subject to CPO or CTA registration under current rules and interpretations. The no-action relief must be claimed through the filing of a notice with the National Futures Association (NFA) and the CFTC and a disclosure to prospective and existing pool participants. The no-action relief would be temporary and would be superceded by any final action taken by the CFTC as a result of the rulemaking.

To make a claim for such no-action relief from CPO registration, the CPO must represent the following with respect to its pools:

- participation in the pool is restricted to accredited investors, knowledgeable employees, non-United States persons, and certain other persons; and
- the aggregate notional value of each pool's commodity interest positions, whether entered into for *bona fide* hedging purposes or otherwise, does not exceed 50% of the liquidation value of the pool's portfolio, after taking into account unrealised profits and unrealised losses on any such positions it has entered into (the Notional Test).

To make a claim for such no-action relief from CTA registration, the CTA must represent the following with respect to the pools it advises:

- it claims the CPO registration relief described above and its commodity trading advice is used solely for pools that it operates; or
- it is registered as an investment adviser under the Advisers Act or state laws or is exempt therefrom; the commodity trading advice is used solely for pools operated by CPOs that claim the CPO registration relief noted above; the advice is solely incidental to the CTA's securities advice to the pool; the CTA employs only strategies that are consistent with the Notional Test described above; and the person does not otherwise hold itself out as a CTA.

<sup>169</sup>. Under CFTC regulations, qualified eligible persons are defined by reference to whether a person meets certain specified financial criteria (the 'portfolio requirement'). Portfolio requirement means that a person: (a) owns unaffiliated securities with an aggregate market value of US\$2 million; (b) has had on deposit with a futures commission merchant within the six months preceding investment in the pool at least US\$200,000 in exchange-specified initial margin and option premiums for commodity interest transactions; or (c) owns a portfolio comprised of a combination of the funds or property specified in (a) and (b) above in which the percentage of the requirement of each category added together equals 100%. Entities not required to meet the portfolio requirement to be considered qualified eligible persons are: (i) registered futures commission merchants; (ii) registered securities brokers or dealers; (iii) CPOs which have been registered and active for at least two years or which operate pools having total aggregate assets in excess of US\$5 million; (iv) commodity trading advisers which have

been registered and active for at least two years or which provide trading advice to commodity accounts having total aggregate assets in excess of US\$5 million; (v) investment advisers which have been registered and active for at least two years or which provide securities investment advice to securities accounts having total aggregate assets in excess of US\$5 million; (vi) 'qualified purchasers' as defined in s. 2(51)(A) of the Investment Company Act; (vii) 'knowledgeable employees' as defined in SEC Regulation 3c-5; (viii) with respect to a commodity pool operated pursuant to an exemption under s. 4.7 of the CFTC Regulations: (a) the commodity pool operator, the commodity trading adviser or the investment adviser of the pool or an affiliate of any of the foregoing; (b) a principal of the pool or the principal of the commodity pool operator, the commodity trading adviser or the investment adviser of such pool; (c) certain employees of the pool; or (d) the spouse, child, sibling or parent of any person described in (viii)(a)–(c) above, provided that the investment in the pool is being made with the knowledge and at the direction of such person, and the spouse, child, sibling or parent is not a qualified eligible person for certain purposes of the CFTC Regulations; (ix) with respect to persons described in (viii), (a) any person who acquires an interest in the pool by gift, bequest or separation agreement from any such persons, (b) the estate of any such persons, or (c) a company established by such persons exclusively for the benefit of such persons and certain other persons; (x) a trust which was not formed for the specific purpose of participating in the pool and the trustee or other person authorised to make investment decisions with respect to the trust, and each settlor or other person who has contributed assets to the trust, is a qualified eligible person; (xi) s. 501(c)(3) organisations (as specified in the Code), provided that the trustee or other person authorised to make investment decisions with respect to such organisation, and the person who has established the organisation, is a qualified eligible person; (xii) non-United States persons which includes: (a) individuals who are not residents of the US; (b) partnerships, corporations, or other entities, other than entities organised principally for passive investment, organised under the laws of a foreign jurisdiction and which have their principal place of business in a foreign jurisdiction; (c) estates or trusts, the income of which is not subject to US income tax regardless of source; (d) certain entities organised principally for passive investment such as a pool, investment company or other similar entity; and (e) pension plans for the employees, officers or principals of an entity organised and with its principal place of business outside the US; (xiii) entities

in which all of the unit owners or participants are qualified eligible persons; (xiv) commodity pools that are operated pursuant to an exemption under s. 4.7 of the CFTC regulations; and (xv) entities as to which a notice of eligibility has been filed. Requirements to be considered qualified eligible persons are: (i) registered investment companies or business development companies; (ii) certain banks; (iii) certain insurance companies; (iv) certain government investment plans for employees; (v) certain employee benefit plans; (vi) private business development companies; (vii) s. 501(c)(3) organisations (as specified in the Code) with assets in excess of US\$5 million; (viii) certain corporations, Massachusetts or similar business trusts, or partnerships with assets in excess of US\$5 million and not formed for the specific purpose of investing in the pool; (ix) natural persons whose individual net worth, or joint net worth with spouse, at the time of purchase of an interest in the pool, exceeds US\$1 million; (x) natural persons with an individual annual income in excess of US\$200,000 in each of the two most recent years or joint income with spouse in excess of US\$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year; (xi) certain pools, trusts, insurance company separate account or bank collective trusts not formed with the specific purpose of investing in the pool; and (xii) certain authorised governmental entities.

<sup>170</sup> 17 C.F.R. § 30.4(c). Previously, CFTC staff interpretations also required that all participants in the pool be qualified eligible persons. That requirement has now been dropped, although disclosure requirements are increased if all participants are not qualified eligible persons.

<sup>171</sup> 17 C.F.R. § 30.5.

<sup>172</sup> See also Appendix A to § 30.10.

<sup>173</sup> See 'Foreign Instruments Approvals and Exemptions' as posted on the CFTC's website at [www.CFTC.gov](http://www.CFTC.gov).

<sup>174</sup> Section 1a(4).

<sup>175</sup> Regulation s. 4.10(d)(1).

<sup>176</sup> Regulation s. 4.10(a).

<sup>177</sup> Edward F. Greene, et al, *US Regulation of International Securities & Derivatives Markets* §§ 11.12[1][b]n.280.

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- <sup>178</sup>. Special provisions have been adopted to facilitate Canadian investment companies obtaining such orders. See Rule 7d-1 under the Investment Company Act. Also, the SEC has adopted Rule 7d-2 under the Investment Company Act, which allows certain non-US investment companies to make, without registration under the Investment Company Act, what would otherwise be public offerings to Canadian expatriates resident or temporarily present in the United States, as long as such persons purchase the shares of such companies in their Canadian tax-deferred accounts and other conditions in the Rule are met.
- <sup>179</sup>. Order issued to Pan Australian Fund Limited, Investment Company Act Release Nos. 7795 (30 April 1973) and 8028 (10 October 1973).