Cross-border regulations a growing risk for GPs

As national regulators reach across borders to protect domestic investors, fund managers will need to answer to multiple authorities.

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Navigating your own country's labyrinth of rules and regulations is already a challenge for fund managers. But the task is growing more daunting as compliance increasingly means understanding and adhering to policies enacted by foreign governments, too.

On both sides of the Atlantic regulators are in the process of crafting unprecedented compliance requirements GPs will soon need to meet. While their authority will be constrained by borders, the impact of their efforts will extend across jurisdictions – in part due to the increasingly international nature of private equity markets.

The US Foreign Account Tax Compliance Act (FATCA) is a prime example of a regulation with far-reaching (and muddled) consequences. Starting in 2013 non-US financial institutions, a term broad enough to capture private equity funds, will need to register themselves with US tax authorities or stomach a 30 percent withholding tax on their US-sourced income.

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>
> *Francisco Duque*

The law, designed to clampdown on US taxpayers shifting income offshore to avoid tax, forces foreign firms to provide US authorities the name, address, tax identification number, and a hodgepodge of other financial details of their US investors used to sniff out tax cheats. To this end, fund managers in particular are facing a bureaucratic nightmare.

Identifying which fund investors count as US-based for reporting purposes is not always a simple task. A series of intermediaries can rest between an LP and the ultimate end investor, meaning GPs will need to peel back several layers of ownership to discover their nationality. Imagine a "privately held company as an LP, which is owned by a number of high-net worth individuals. That company would need to disclose any US owners that have more than a 10 percent interest in the company, and in some cases any US owner, in order for the fund to be able to make payments to it free of US withholding tax," says Francisco Duque of Linklaters, a law firm.

Plus there's no guarantee an end-investor would even respond to a request for information, warn legal sources, who envision inattentive end investors leaving information request letters unopened, unaware of their importance.

The larger issue, however, may be that it's unclear if GPs are legally allowed to transfer such information to US tax authorities. Local data privacy rules could prevent firms from sharing sensitive information across borders, resulting in a clear conflict of law, says Duque. "For example, EU data protection rules could limit the disclosure of this information, unless the LP consents to the disclosure."

Operational challenges will accompany the law as well. As a result of FATCA, GPs may need to reform their firms' payment systems, review distribution channels and reporting practices. Or, if these administration tasks are outsourced, to ensure the third-party service provider is capable of meeting incoming FACTA requirements.

The IRS says it is aware of the challenges in FATCA implementation and is expected to issue updated guidelines by the end of the year, according to Duque.

The confusion and complexities has resulted in only one-third of fund managers being ready to meet FATCA deadlines, according to a June KPMG survey. And less than half (42 percent) of the undisclosed number of respondents have assessed the time needed to comply. The finding is worrying considering KPMG's view that "unless implementation is postponed, we believe that the correct answer to the question of when preparations for FATCA should begin is 'six months ago'".

Overseas watchdog

Leaving the new tax complexities aside, non-US firms (with US ambitions) must also begin assessing whether they will soon fall under the eye of the US Securities and Exchange Commission (SEC) – the agency now responsible for supervising alternative investment funds operating in the country as a result of the Dodd-Frank Act.

Full registration with the SEC will subject firms to detailed reporting and disclosure requirements. The process can also mean racking up hundreds of thousands of dollars in compliance costs, according to various estimates, prompting some GPs to bypass US investors. As such, many foreign firms will hope to rely on certain exemptions provided by the SEC.

Firms with a minimal US presence – defined as having no US office and managing less than $25 million (from fewer than 15 US-based LPs) – can rely on a "Foreign Private Advisor" exemption and need take no action.

Foreign firms with larger US operations may seek a SEC-lite registration regime by claiming "Exempt Reporting Advisor" status. Exempt advisors face a "fairly simple" registration process, says Ben Blackett-Ord of Bovill, a compliance consultancy firm, and can "largely be done online with a bit of hand holding from a US advisor". GPs that are considered to manage "venture capital" funds (as defined by the SEC) or those managing less than $150 million of US assets can claim exempt status.

Karsten Langer, Brussels-based partner of global mid-market firm Riverside and chairman of the European Private Equity and Venture Capital Association (EVCA), says his firm will undergo full registration with the SEC, a process involving significantly more paperwork. To do so the firm has invested in new software designed to monitor compliance obligations. The system for instance monitors employees' outside trading activity, a conflict of interest disclosure required under SEC registration. "Every employee has a questionnaire they need to regularly submit into the software," says Langer.

New anti-bribery laws in the UK and increased enforcement of the US Foreign Corrupt Practices Act are other areas of global regulatory concern, notes Langer. The laws call for GPs to undergo greater due diligence efforts in the battle against corruption. The UK government for example stresses that no knowledge of a bribe taking place either on home soil or in foreign countries could be considered a legitimate defence in court.

As such Riverside has designed new training courses for all its employees and portfolio companies must now document their awareness and compliance to the beefed-up laws against backhanders.

Additional legal talent has also been brought on to handle the new measures, says Langer, adding it will be smaller firms who will struggle to meet the compliance costs attached to SEC registration, FACTA reporting and anti-bribery safeguards.

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Firms of all sizes may also grapple with a difference in regulatory approach among the various national authorities, say market sources. The SEC, for example, tends to have a more prescriptive approach in its supervision, while the UK's Financial Services Authority, in comparison, is more principle-based and flexible in its attitude. On the other hand, SEC registration is a more straight-forward process relative to European standards (generally speaking), says one London-based funds lawyer.

Overall, if cultural and historical ties are anything to go by, falling under the purview of US or EU regulators shouldn't necessarily be something keeping fund managers awake at night.

Building blocs

The European Union will soon expand its own jurisdictional reach through its Alternative Investment Fund Managers (AIFM) Directive – a new piece of legislation designed to screen non-EU funds looking to access the continent's qualified investors. The directive is still going through the rulemaking process – with implementation expected in 2013 – but clues to its final form were provided when technical advice was submitted to EU policymakers last November.

Most notably, the advice pulled back from a regulatory "equivalency test" for non-EU regulators to meet. In original form, the test required non-EU fund managers' local jurisdictions to match the AIFM directive or forgo EU investors.

However some in the industry have criticised the advice as being too vague. Uncertainty around co-operation agreements, which "third-country" jurisdictions must sign to allow local funds EU marketing rights, remain inexplicit.

Regarding co-operation agreements, the European Securities and Markets Authority (ESMA), the body responsible for drafting the technical advice, suggests it centrally negotiate a multilateral memorandum of understanding for member states to use. ESMA said it would look to existing international standards in shaping its template – particularly those offered by the IOSCO Multilateral Memorandum of Understanding (MoU) overseen by the International Organisation of Securities Commissions – a move welcomed by many offshore jurisdictions.

The EU government is expected to fine-tune the core provisions of the directive, using ESMA's advice, by next July.