



## Alternative Investment Management Association

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Dear Sir / Madam,

### Foreign Account Tax Compliance ('FATCA')

The Alternative Investment Management Association Ltd (AIMA) is pleased to have the opportunity to comment on Chapter 4 of the Internal Revenue Code of 1986 entitled 'Taxes to Enforce Reporting on Certain Foreign Accounts', which was enacted as part of the Hiring Incentives to Restore Employment Act of 2010 (H.R. 2847) on 18 March this year.

We are responding to the request of the Treasury Department and the Internal Revenue Service (the IRS) for comments from the public regarding guidance projects and issues concerning the interpretation and implementation of Chapter 4 of the Internal Revenue Code of 1986 (which we shall refer to simply as FATCA).

#### About AIMA and its members

Founded in 1990, AIMA is the global representative of the hedge fund industry. We represent all practitioners in the alternative investment management industry - including hedge fund managers, funds of hedge funds managers, prime brokers, legal and accounting services, fund administrators and independent fund directors.

Our hedge fund manager members manage in excess of 75% of global hedge fund assets and 70% of global funds of hedge funds assets.

Our membership is corporate and comprises over 1,100 firms (with over 4,500 individual contacts) in more than 40 countries. They all benefit from our active influence in policy development, our leadership in industry initiatives and our outstanding reputation with regulators.

We address the real issues affecting the industry's development and represent the global hedge fund industry at national, European and international levels in ongoing discussions about the future regulatory and fiscal framework for the industry.

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### AIMA's submissions on specific provisions of FATCA

AIMA understands that the intention of FATCA is that Foreign Financial Institutions ("FFIs") and Non-Financial Foreign Entities ("NFFEs") should obtain and report information regarding U.S. customers and beneficial owners to the IRS. AIMA acknowledges that FATCA forms part of the U.S. Government's initiatives to detect U.S. taxpayers who evade tax through offshore holdings and to discourage such practices. Whilst we welcome these measures, we request that Treasury, in forming the regulations and guidance on interpretation and implementation of FATCA, provides clarification, detail and guidance on the specific matters set out here, to address our members' concerns.

#### A. Widely Held Investment Vehicles, Interests sold through Distributors/Intermediaries which are FFIs and Investments made by FFIs

##### Widely Held Investment Vehicles

In general, under Section 1471, a Foreign Financial Institution is required to comply with certain reporting requirements regarding certain specified U.S. Financial Accounts. Section 1471(d)(2) provides for the definition of a Financial Account, which could include any equity or debt interest in such financial institution (other than interests which are regularly traded on an established securities market). Section 1471(b)(2) provides the Treasury with authority to deem certain entities in compliance with their FFI agreements to the extent that they satisfy certain prescribed requirements. The Joint Committee on Taxation provided the following comment in its Technical Explanation of the Revenue Provisions in the HIRE Act:

"For instance, it is anticipated that the Secretary may provide rules that would permit *certain classes of widely held collective investment vehicles*, and to the limited extent necessary to implement these rules, the entities providing administration, distribution and payment services on behalf of those vehicles, *to be deemed to meet the requirements of this provision.*"

We believe that the Internal Revenue Service and the Treasury Department should create a sub-category of FFI, governing widely held collective investment vehicles that are similar in many ways to exchange-traded funds.

This approach is based on the fact that:

- i) information as to the identity of investors in collective investment funds is often held by transfer agents or other intermediaries and the investor base itself is subject to frequent change as investors move in and out of investments in the collective investment fund;
- ii) an investor typically would need to hold his interest in the investment vehicle and/or transfer funds to acquire his interest or receive distributions through a securities firm, bank or other FFI, which would itself be obligated to report U.S. accounts; and
- iii) in many situations, there are already prohibitions on actively marketing such vehicles to U.S. persons to avoid U.S. security law obligations (which prohibitions also apply to intermediaries holding interests in the funds).

Moreover, as discussed below, many of these funds already have well-developed procedures in place in order to comply with existing know-your-customer and anti-money-laundering rules. Where the interests are sold via distributors/intermediaries, funds rely on the anti-money laundering procedures of those intermediaries, undertaking an extensive due diligence process at the outset to ensure that such procedures comply with the standards of the relevant jurisdiction. All of these factors should provide adequate safeguards against unidentified U.S. holders.

Collective investment funds in this category, including hedge funds, should be deemed to meet the reporting requirements of Section 1471 by disclosing any U.S. accounts with whom the vehicle has direct privity and whom the vehicle knows is a specified U.S. person (including through a known nominee or other agent of such person). Specifically, in this scenario, the FFI agreement relating to these collective investment funds would require the

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FFI to disclose those U.S. owners, on an annual basis, to the IRS (or, alternatively, to its U.S. withholding agent which, in turn, would disclose the U.S. owners to the IRS).

We believe that there are strong reasons for this procedure. Given the administrative burdens that the IRS faces in managing the execution, implementation, and subsequent enforcement of a large number of FFI agreements, creating a sub-category of FFI with a simplified agreement would benefit the IRS, as collective investment funds are estimated to be the largest category of FFI.

### Interests sold through Distributors/Intermediaries which are FFIs and Investments made by FFIs

In the case of a collective investment fund (whether widely held or otherwise) which sells its interest via a distributor or intermediary, there may be valid commercial reasons which preclude the distributor/intermediary from disclosing the identities of the underlying investors in the fund. To illustrate this point, we wish to highlight a scenario which is common in practice:

A Luxembourg issuer distributes paper with the UCITS brand name through DL bank<sup>1</sup>. DL Bank is solely a distributor/paying agent and it places the Luxembourg issuer's paper with its own private wealth clients. DL Bank acts as agent with respect to payments, although it does not tell the Luxembourg issuer the identity of the owners of the paper. The reason for this is that DL Bank does not want to disclose its own private wealth clients because the Luxembourg issuer is connected to a rival bank that will try to poach those clients.

The paper is either a debt or equity interest in the Luxembourg issuer and, therefore, an account. Assuming DL Bank is an FFI, it will have entered into an FFI agreement and reported the holders of the paper as a custodial account. Where the Luxembourg issuer is also an FFI, it will need to obtain information as to U.S. and foreign accounts and report to the IRS. The Luxembourg issuer would need to know who owns its paper in order to comply with an FFI agreement with the IRS. However, because DL Bank will not disclose who is holding the paper, the Luxembourg issuer cannot comply with the FFI agreement. Thus, absent an exemption, the Luxembourg issuer will suffer U.S. withholding tax on U.S.-source dividend or interest income that is linked to the paper which is distributed by DL Bank.

The same issue is likely to arise in the context of a fund of funds (FOF), i.e., a fund which invests in other underlying funds. A FOF will generally resist disclosing its investors to an underlying fund to prevent that fund competing for the FOF's clients. Provided the FOF has entered into an FFI agreement and disclosed the relevant information to the IRS, we believe that the underlying fund should be deemed to meet the reporting requirements of section 1471 if it obtains a statement from the FOF which certifies that the FOF has entered into an FFI agreement with the IRS and has complied with its reporting obligations in relation to any U.S. accounts. Similarly, in the first scenario above, it should be sufficient that the Luxembourg issuer obtains a statement from DL Bank that the distributor has entered into an FFI agreement and provided all relevant information to the IRS.

This solution would, in our view, be consistent with the objectives of FATCA whilst at the same time preventing duplicative reporting and/or unnecessary withholding.

As a related point, the regulations should provide guidance on whether an administrator of an FFI can rely on certification provided by a third party. For example, in the FOF example above, it would be more practical if the underlying fund's administrator could rely on a statement provided by the FOF's administrator rather than having to obtain certification from the FOF directly.

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<sup>1</sup> UCITS branded paper has been used in this scenario but privately placed debt would be another example.



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### B. Information reporting agreements with the Treasury

An FFI, under its agreement with the Secretary of the Treasury, must:

- a. obtain information on its account holders sufficient to determine which of the account holders are specified U.S. persons or foreign entities substantially owned by specified U.S. persons (IRC § 1471(b)(1)(A)); and
- b. then provide the Secretary with identifying information regarding each identified specified U.S. person (*Id.* § 1471(c)(1)(A)).

Of paramount importance are the content and format of the agreement that an FFI must enter into with the Secretary. We recommend that, although there is flexibility for the Secretary to enter into customized agreements, the Treasury should also develop standardized agreements based on the characteristics of different classes of FFIs (for example, banks, widely-held investment vehicles, and smaller funds), taking into account the jurisdictions in which they currently operate.<sup>2</sup>

We believe that Treasury can and should have several levels of standardized agreements, and that the requirements for collective investment funds should take into account the fact that most funds do not have the operational and administrative resources which are available to large global financial institutions.

These agreements should rely on the existing know-your-customer and anti-money laundering rules, providing a safe harbour for FFIs who identify U.S. accounts through procedures that are compliant with the regimes of their home countries.

### Financial Action Task Force ("FATF") Recommendations and Assessments

The Joint Committee on Taxation anticipated that the Secretary "may use existing know-your-customer, anti-money laundering, anti-corruption, and other regulatory requirements as a basis in crafting due diligence and verification procedures" designed to ensure that the FFI has identified specified U.S. persons.<sup>3</sup> These procedures are commonly referred to as anti-money laundering / combating the financing of terrorism ("AML/CFT") rules.

A variety of resources is available to Treasury to analyze the strength of AML/CFT regimes in different countries, in order to establish that an FFI's compliance with existing AML/CFT procedures should operate as a safe harbour. For example, the Financial Action Task Force ("FATF") is an inter-governmental body that develops and promotes anti-money laundering policies. FATF has published Forty Recommendations on Money Laundering (and an additional Nine Special Recommendations on Terrorist Financing), most recently updated in 2003 ("Recommendations"). These Recommendations are widely relied upon internationally and are recognized as "best practices" for identifying and prosecuting persons engaged in these activities.

FATF's recommended customer due diligence involves verifying the customer's identity and the identity of the beneficial owner of the account, obtaining information on "the purpose and intended nature of the business relationship," and "[c]onducting ongoing due diligence" throughout the customer relationship (FATF Recommendation 5). The FATF Recommendations allow a "risk-based" approach, which requires additional due diligence procedures regarding those persons who are deemed higher risk, to ensure the most efficient use of resources.

FATF (and also the International Monetary Fund ("IMF")) conducts regular assessments of the AML/CFT practices of various countries - including offshore finance centers ("OFCs") such as Switzerland and Singapore - to determine compliance with FATF Recommendations. The assessment programme has been successful. OFCs in

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<sup>2</sup> The Treasury should also ensure that these agreements are coordinated with the existing qualified intermediary rules.

<sup>3</sup> Joint Comm. on Tax'n, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, The "Hiring Incentives to Restore Employment Act," Under Consideration by the Senate, JCX-4-10 February 23, 2010 (hereinafter JCT Report), at page 40.

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particular “have freely volunteered for assessment” and “[have taken] the lead in publishing their assessment reports.”<sup>4</sup> FATF assessments are widely relied upon in the industry.

### *European Union Third Directive on Money Laundering*

The European Union’s Third Directive on Money Laundering (“Third Directive”) was implemented in December 2007 to bring members of the EU in line with the Anti-Money Laundering recommendations of FATF. The Third Directive requires Member States of the EU to implement know-your-customer rules that are more stringent than those required in the U.S., in that they require covered institutions to not only identify and verify the beneficial owner of the customer, but also to understand the ownership and control structure of the customer.<sup>5</sup> The Third Directive uses the “risk-based” approach advocated by FATF and requires ongoing account monitoring over the course of the business relationship.<sup>6</sup>

In the UK, for example, the Third Directive was implemented through the Money Laundering Regulations 2007.<sup>7</sup> These regulations apply to credit institutions, banks, investment service companies, collective investments and certain insurance companies, among others. Customer due diligence procedures required by the Third Directive must be undertaken whenever a business relationship is established, an occasional transaction is carried out, money laundering or terrorist financing is suspected, or there is doubt as to the veracity or adequacy of the data previously obtained for purposes of identification and verification. If these procedures cannot be completed, the business relationship must be terminated. Enhanced due diligence and ongoing monitoring are required where money laundering or terrorist financing is suspected, where the customer is not physically present for identification, or in the case of certain political figures.

### *Offshore Finance Centres*

FATF and IMF assessments of OFCs “have shown that many OFCs are performing as well as many onshore centres” in implementing AML/CFT regimes.<sup>8</sup> OFCs have significant reputation risks if they are seen as noncompliant with international norms and, therefore, have worked to significantly improve their practices in recent years. Some OFCs have sophisticated KYC rules. In fact:

“On the matter of access to information on the beneficial ownership of corporate vehicles, ... the OFCs generally are significantly better placed than most if not all onshore centres largely because of the requirements they place upon trust and company service providers as a condition of their obtaining a necessary license to operate”.<sup>9</sup>

For example:

- The Swiss Anti-Money Laundering Act governs virtually all Swiss financial intermediaries, including banks, fund managers, security dealers, insurance companies, and foreign exchange traders. The Act requires financial intermediaries to verify the identity of their contracting partners at the beginning of the relationship by examining official documents such as passport or identity card. If there is a doubt as to whether the contracting party is the beneficial owner, the financial intermediary must request the identification of the beneficial owner. If the customer is a legal entity, the financial intermediary must determine the ownership and control of the entity if it is a domiciliary company or engaged in a high-risk

<sup>4</sup> Colin Powell CBE, *Anti-Money Laundering from an Offshore Finance Centre Viewpoint*, in TAX PLANNING INT’L SPECIAL REPORT: ANTI-MONEY LAUNDERING [hereinafter BNA SPECIAL REPORT], (BNA November 2007), at page 9. OFC Assessments are available online at <http://www.imf.org/external/np/ofca/ofca.asp> and [http://www.fatf-gafi.org/info/country/0,3380,en\\_32250379\\_32236963\\_1\\_1\\_1\\_1\\_1,00.html](http://www.fatf-gafi.org/info/country/0,3380,en_32250379_32236963_1_1_1_1_1,00.html).

<sup>5</sup> JCT REPORT, *supra* note **Error! Bookmark not defined.**, at page 38. The beneficial owner is defined as the natural person who ultimately owns or controls the customer (25% direct or indirect ownership or control in the case of a corporation), on whose behalf the transaction or activity is being conducted, and/or who otherwise exercises control over the management of the corporation. *Id.* at page 38-39.

<sup>6</sup> *Id.* at page 39.

<sup>7</sup> Statutory Instrument 2007 No. 2157, [http://www.opsi.gov.uk/si/si2007/pdf/uksi\\_20072157\\_en.pdf](http://www.opsi.gov.uk/si/si2007/pdf/uksi_20072157_en.pdf).

<sup>8</sup> *Id.* at 10.

<sup>9</sup> *Id.*

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business transaction. This identity check must be repeated every time doubts arise during the course of the relationship. If a financial intermediary active in the banking sector deems a client or transaction to be risky, heightened due diligence procedures apply.<sup>10</sup>

- The Cayman Islands Money Laundering Regulations make it an offence to engage in "relevant financial business" without maintaining procedures for client identification, record keeping, internal reporting, and staff training.<sup>11</sup> The IMF issued its report on the Cayman Islands' AML/CTF regime in 2005, finding (at pages 30, 32-33) that "[e]fforts to achieve compliance with international standards have been a top priority" in the Cayman Islands and that the Cayman Islands Monetary Authority's Guidance Notes, which are used by courts to determine compliance with regulations, "reflect international standards and best practices regarding customer identification, record keeping," and other areas. That regulatory authority "places great emphasis on strong due diligence in licensing and KYC for all prudentially regulated sectors," including banks, insurance, mutual funds, securities investments, corporate and trust service providers, and money services businesses.<sup>12</sup>

Given the active and effective monitoring performed by FATF and the IMF, the Treasury should make use of current AML/CFT regulations. We recommend that the standard FFI agreement provides a safe harbour for FFIs who comply with their country's AML/CFT regime and who identify and report U.S. accounts based on the information gathered under those procedures. If Treasury considers that the AML/CFT rules of certain countries are not sufficient to meet what is required under an FFI agreement, then Treasury could provide a list of the AML/KYC requirements which do comply and permit funds domiciled in jurisdictions which are not approved to opt into those requirements in order to fall within the safe harbour.

Finally, it would be helpful if the IRS could make a resource available which enables fund administrators and other service providers to verify if there is a current agreement between an FFI and the Treasury.

### C. Financial accounts

Guidance is required which clarifies and limits the definition of a "financial account" - as defined in Section 1471(d)(2) - in connection with certain financing and hedging transactions. Certain investment products - such as total return swaps and other derivatives - provide exposure to a fund's performance, but should be expressly excluded from "financial account" classification, given that a fund does not have access to the party to the derivative and the party has not ultimately invested in the fund. The Secretary should also make clear whether short-term obligations or short-term deposits that pose a low risk of U.S. tax evasion (e.g., those with a term of no more than one year) will be treated as "financial accounts" under FATCA.

The Regulations should also establish whether, for purposes of Section 1471, "regularly traded on an established securities market" - given the cross-border context - will retain the same meaning used in Sections 897, 1445, and 6039C:

Treas. Reg. § 1.897-1(m) - Established securities market. For purposes of sections 897, 1445, and 6039C, the term "established securities market" means-

- (1) A national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f),
- (2) A foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and
- (3) Any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to

<sup>10</sup> See generally Jean-Blaise Eckert and Daniel Tunik, *Anti-Money Laundering in Switzerland*, in BNA SPECIAL REPORT, *supra* note 4, at page 21, 21-22.

<sup>11</sup> See generally Andrew Bolton, *Anti-Money Laundering in the Cayman Islands*, in BNA SPECIAL REPORT, *supra* note 4, at page 71, 72.

<sup>12</sup> IMF, *Cayman Islands: Assessment of the Supervision and Regulation of the Financial Sector - Volume I - Review of Financial Sector Regulation and Supervision*, at page 30, 32-33; available at <http://www.imf.org/External/Pubs/FT/SCR/2005/cr0591.pdf>.

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brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

Regulations should address over-the-counter markets specifically. FATCA provisions as enacted will also require further clarity in debt and distressed market contexts. The Regulations should clarify what debt interests are considered "financial accounts" and address situations that include:

- (a) private placement debt where third party investors are unknown to the fund, and
- (b) repurchase agreements, total return swaps, and other leverage undertaken with dealers who themselves may be U.S. persons or FFIs where such arrangements do not pose a significant risk of tax evasion.

Deep-in-the-money options, non-debt open transactions - for example, pre-paid forward contracts and credit default swaps - will also require consideration in published guidance if FFIs are to understand how to apply FATCA.

### D. Reporting Gross Receipts and Withdrawals

#### Scope and scale of reporting requirements

Forthcoming Treasury Regulations under FATCA should clarify four main issues for taxpayers regarding the scope and scale of the reporting requirements. They must:

1. clearly define what is to be reported and provide examples (including those applicable to reporting by foreign investment funds);
2. clarify whether the IRS requires a complete transcript of account movements, or information about certain transactions only;
3. clarify that the investment activity of an FFI - for example, an investment fund - itself does not need to be reported, but only U.S. account holders' subscriptions and redemptions; and
4. address how foreign entities whose values are denominated in foreign currencies should be reported.

FATCA provides that an FFI must report the name, address, and TIN of each account holder that is a U.S. person or of each substantial U.S. owner of any account holder that is a U.S. owned foreign entity (each such account, a "Reportable Account").

FATCA also requires reporting of the account balance or value, as well as the gross receipts and withdrawals, of all Reportable Accounts.

- In lieu of reporting account values, receipts and withdrawals, an FFI may elect and report under Sections 6041, 6042, 6045, and 6049 of the Code as if it were a U.S. person.
- The reporting guidelines should clarify that neither a complete record of account movements nor a description of a fund's investment activities is required. A clause specifically excluding such information from the requirements should be added.
- FATCA also requires reporting of each Reportable Account's account number, but private investment funds generally do not have account numbers. Therefore, this requirement should be deleted or perhaps replaced with the date on which the account was created.
- For account balance or value, a figure such as year-end net asset value would be the most appropriate and useful reporting requirement for most hedge funds, as hedge funds generally do not calculate net asset value on a daily basis.

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The Secretary should provide special procedures for existing U.S. account holders given that institutions and funds may have difficulty procuring the required information from these holders after the fact. For example, the institution might be treated as having satisfied its reporting obligations if none of its existing information on file for such a holder indicates direct or indirect ownership by U.S. persons.

### E. Additional matters

We would also like to raise these additional matters for consideration and on which we may, if appropriate at a later point in time, wish to make further requests for clarification or guidance:

**Closing accounts:** The regulations which deal with the closing of accounts should distinguish between existing account holders and prospective account holders. As mentioned in the final paragraph of section D above, a fund may have difficulty procuring the required information from an existing holder "after the fact", and therefore the regulations should address the situation where a fund has exhausted all reasonable means to seek out information from an existing account holder. The regulations should also address situations where there are legal or contractual restrictions on closing an account (eg, investments in a fund may be subject to 'lock in period' such that the fund is unable to force out a recalcitrant account holder, or, where the fund holds illiquid assets, the fund may be unable to return assets to the investor in the short term).

**Non-U.S. funds treated as partnerships:** Consideration should be given to the relative benefits of implementing FATCA with respect to non-U.S. investment funds that are treated as partnerships for U.S. tax purposes. U.S. source dividends, interest and securities gains derived by a U.S. person through a foreign investment partnership are currently subject to duplicative reporting. The foreign partnership must report the U.S. person's distributive share of such items on a Schedule K-1. In addition, the U.S. broker or other payer that effects the payment of such items must report such payments on a Form 1099. Such redundancy presents a low risk of tax evasion for U.S. investors in foreign investment partnerships.

**Multi-tiered structures (e.g. master-feeders):** The regulations should be clear as to the information which would be required to be obtained by a lower-tier FFI when an upper-tier FFI that has an agreement in place invests in such lower-tier FFI (i.e., the upper-tier FFI becomes an account holder of the lower-tier FFI). Ideally, the lower-tier FFI should be able to rely on the fact that the upper-tier FFI has already entered into its own agreement regarding its account holders.

**Total Return Swaps/Derivatives on Private Investment Funds and Dividend Equivalent Payments:** In addition to considering whether total return swaps and similar financial products in respect of private investment funds constitute "financial accounts", as discussed in section C above, Treasury should clarify that the scope of the term "dividend equivalent payment" does not, as a general matter, require looking through pools of investments and/or corporate entities simply because there is some investment by the pooled investment vehicle or corporation in U.S. stock. Rather, the law covers situations that provide a direct, though synthetic, economic exposure to the underlying U.S. stock return. For example, if there is a swap on equity of a U.K. corporate entity, payments made in respect of such swap should not be viewed as a "dividend equivalent payment" simply because the U.K. entity has a U.S. corporate subsidiary.

Should you have any questions on our letter or wish to have any more detail on any point, please let me know.

Yours faithfully,

Mary Richardson  
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