PROSKAUER ROSE LLP

# Private Investment Funds

## Update

DECEMBER 2008

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This edition of our Private Investment Funds Update summarizes recent developments that have potential impact on hedge funds, private equity funds and other alternative investment funds.

## Bernard Madoff Case

Proskauer has formed a task force to address the issues facing clients of the firm regarding the fraud involving Bernard Madoff. This task force includes individuals from the corporate, litigation, labor (pension) and tax groups. Clients should contact us with any questions or concerns regarding this matter and any options for recovery.

## December 31, 2008 Deadline for Deferred Fees

As we have noted in previous updates, a new U.S. tax provision, Code Section 457A, adopted as part of the Emergency Economic Stabilization Act of 2008, essentially precludes all future deferred fee arrangements with offshore hedge funds. The new provision imposes a 20% excise tax on certain deferred compensation from any "nonqualified entity" with respect to services performed after December 31, 2008, if the amount is not determinable when it is no longer subject to a "substantial risk of forfeiture" as narrowly defined in 457A and requires any existing deferrals to be included in income prior to 2018.

December 31, 2008 is also the final deadline for all existing written arrangements related to deferred fee arrangements (other than certain grandfathered arrangements) to comply with Code Section 409A.

All hedge fund managers should consider amending their existing deferred fee arrangements before the end of 2008 in order to ensure that no existing deferred fees are payable after 2017. Hedge fund managers should also consider whether to utilize current transition relief under Code Section 409A to change any of their existing deferred fee arrangements, since they still have one last opportunity under the transition rules to make certain changes to existing deferred fee arrangements before December 31, 2008. Hedge fund managers should also generally consider whether any existing deferred fee arrangements should be converted into an allocation of income. An income allocation also has the potential benefit of allowing the manager to receive capital gain treatment with respect to certain income.

“Nonqualified entities” include (i) any foreign corporation unless substantially all of its income is effectively connected with a U.S. trade or business or subject to a comprehensive foreign income tax and (ii) any partnership (domestic or foreign) unless substantially all of the partnership’s income is allocated to persons other than tax-exempt organizations or foreign persons not subject to a comprehensive foreign income tax. For these purposes, a foreign income tax qualifies as comprehensive if the person is eligible for benefits under any comprehensive income tax treaty between the U.S. and a foreign country or otherwise demonstrates to the satisfaction of the Department of Treasury that the country has a comprehensive income tax.

Finally, all managers should review any arrangements they have with any non-taxed non-U.S. entities or U.S. partnerships that have tax exempt investors that provide for fees to be paid in future years in order to ensure that they do not inadvertently trigger the excise tax under Section 457A.

## Release of New SEC Model Examination Document Request List

On November 13, 2008, the SEC’s Office of Compliance Inspections and Examinations (“OCIE”) released its long-awaited model core initial document request list for SEC registered investment adviser exams (http://www.sec.gov/info/cco/requestlistcore1108.htm).

The new list is very similar to the lists used by OCIE in recent years. The SEC may tailor the list to a particular adviser’s business. Regional SEC offices may also tailor the list to reflect their own regulatory priorities.

## SEC Expands Use of Past Specific Recommendations in Advertisements

The SEC has issued a no-action letter expanding the ability of registered investment advisers to use performance analytics in advertisements. In the *TCW Group, Inc.* letter, the SEC stated that it is acceptable for a registered investment adviser to identify “best” and “worst” performers for a particular portfolio in the adviser’s marketing materials.

In *TCW*, the SEC said that it would not recommend enforcement action under Section 206(4) of the Advisers Act or Rule 206(4)-1(a)(2) thereunder against TCW’s registered investment adviser subsidiaries for distributing advertising materials that include charts of “Best Performers/Worst Performers”. The charts demonstrate the effect that individual holdings had on the return during a specified period. Marketing materials including the charts can be distributed to prospective clients and consultants regardless of whether they specifically requested the information.

A registered investment adviser should note that there are a number of conditions set out in the *TCW* letter including:

- Disclosures must be made regarding how the calculations were made;
- The chart must include no fewer than five holdings that contributed most positively to the performance and an equal number of holdings that contributed most negatively to the performance;
- The chart's presentation of information and calculation methodology must be consistent for each measuring period;
- The chart must provide both the average weight of the selected securities in the portfolio and the contribution of the selected securities to the account's overall return; and
- The selected securities must be chosen from all securities during the period in a mechanical and objective manner and based only on their relative impact on the performance of the portfolio during the period.

## New York State Proposes to Tax Carried Interest Earned by Non-Resident Partners

The Governor of New York State, David Patterson, has proposed a provision that would impose New York tax on carried interest income allocated to non-residents of New York. The bill would require that individual partners treat as New York source income their shares of carried interest for investment management services actually performed in New York. Allocations between New York and other states would presumably be based on the portion of the investment management services being rendered in New York, rather than the source of the underlying gains included in the carried interest.

Currently, carried interest is generally characterized as investment income and therefore not treated as New York source income subject to New York tax when allocated to non-residents of New York.

## Annual Compliance Actions for Investment Advisers

At the end of the year approaches, investment advisers should remember to take any actions that must be taken annually (not necessarily based on a calendar year), including:

- offer to provide Part II of Form ADV to all clients (in the case of registered advisers);
- provide annual privacy notices to natural person clients (in the case of both registered and unregistered advisers);
- perform and document an annual review of all compliance programs, policies and procedures (in the case of registered advisers);

- make any required Schedule 13G filings, Form 13F filings and Form 5 filings (within 45 days after the adviser's fiscal year end);
- provide annual VCOC certificates if required by fund partnership agreements; and
- provide any investor specific reporting information as required by any side letters.

## Final Exon-Florio Regulations

The Treasury Department issued on November 14, 2008, new regulations implementing the Exon-Florio Amendment to the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007 ("FINSA"). Compared to the existing regulations, the new regulations increase significantly the scope of transactions subject to Exon-Florio review. The new regulations will take effect on December 22, 2008.

The Exon-Florio Amendment gives the President the authority to investigate, block or unwind mergers and acquisitions by foreign persons that could threaten national security (which is defined broadly and includes critical U.S. infrastructure). Generally, private funds that have a U.S.-based manager will not be deemed to be controlled by foreign persons and therefore not be subject to these rules.

The President's Exon-Florio powers apply whenever a foreign person is acquiring control over an existing U.S. business, directly or indirectly, regardless of whether the U.S. business is already foreign-owned. The parties to an acquisition may voluntarily file for preclearance of such transaction. If the parties do not preclear their acquisition, it could be subject to later divestiture.

Although Exon-Florio provides the President with the power to investigate "mergers, acquisitions, and takeovers . . . by or with foreign persons which could result in foreign control of persons engaged to interstate commerce in the United States," the final regulations apply review powers to transactions that would not normally be thought of as a merger, acquisition, or takeover or as conveying control to a foreign person.

For example, the following transactions may be caught by the final regulations:

- A loan may be subject to review where the foreign lender (which could be a hedge or private equity fund) will acquire an interest in the profits of a U.S. business, the right to appoint board members or "other comparable financial or governance rights characteristic of an equity investment but not a typical loan."
- An acquisition by a foreign person of options, warrants, or convertible debentures that can be exercised for or converted into voting equity may be treated as voting equity for Exon-Florio purposes, depending on such factors as (i) how quickly conversion can occur, (ii) whether conversion depends on factors within the control of the holder, and (iii) whether the relative voting power and other rights that would be acquired upon conversion can be reasonably determined.

Clients should confirm with counsel when completing a U.S.-based transaction whether any preclearance is required.

## Bermuda Court Rejects Distributions in Kind in Gottex Case

The Supreme Court of Bermuda recently made a decision to appoint receivers for a hedge fund that distributed "participating notes" issued by a "liquidating trust" to redeeming investors rather than paying cash or distributing other assets in kind. The decision was issued in an action brought by a fund of funds, Gottex, against a hedge fund in which it had invested, Stewardship Credit Arbitrage Fund, Ltd.

The Bermuda Court concluded that the participation notes distributed by Stewardship to Gottex did not comply with the by-laws of Stewardship and therefore were not valid.

In order to satisfy redemption requests from several of its funds, Stewardship set up a New York liquidating trust. The by-laws and placement memorandum both provided that in-kind distributions were permitted. However, it is clear from the decision that the Court thought that the note was essentially just another name for an IOU from the fund and therefore did not comply with the terms or spirit of the fund's by-laws. It is not clear that the Court would have ruled in the same way had the fund distributed to its investors equity interests in another legal entity, such as shares in a special purpose vehicle or master fund.

The facts of the case are also distinguishable because the fund appeared to be insolvent. The Court determined that the assets that backed up the notes distributed to Gottex were likely worthless, and in any event worth less than the payment due to Gottex as a result of its earlier redemption of its interest in the fund, and that the fund was therefore likely insolvent. A large portion of the assets of Stewardship consisted of loans made to the Petters group. As you may know, Petters is accused of running a $2 billion ponzi scheme and Tom Petters has been in custody since September. Therefore, even if the Court had concluded that the distribution of the notes complied with Stewardship's governing documents, the value of the notes distributed to Gottex likely would not have been enough to extinguish the fund's obligation to Gottex.

## UK FSA Amends Short Selling Measures

The UK Financial Services Authority (the "FSA") carried out its 30-day review of the measures introduced in the Short Selling (No.2) Instrument (the "Short Selling Instrument") and concluded that only one change should be made to the measures introduced in the Short Selling Instrument. The FSA also confirmed that a "comprehensive review of the rules on short selling" would be published in January 2009.

The amendment to the Short Selling Instrument relates to the ongoing disclosure obligations. The disclosure requirements initially required net short positions to be disclosed for each day they were held, even where the position had not changed. In its statement released on October 22, the FSA acknowledged that this was "not a proportionate requirement". Consequently, the FSA introduced an amendment to the Market Conduct sourcebook which stated that, from October 31, 2008, disclosable short positions only had to be disclosed on the first day on which they were held after October 30, 2008 and on "each day on which the disclosable short position changes".

The FSA has been consulting industry groups, such as the Alternative Investment Management Association, on the effectiveness of the current temporary UK short selling rules. The FSA intends to use these responses and comments to help form its views before formally publishing its review on short selling rules in the UK in January 2009.

Our more detailed Client Alert released in relation to the Short Selling Instrument can be viewed at: http://www.proskauer.com/news_publications/client_alerts/content/2008_09_22.

## European Commission to Launch Initiatives on Hedge Funds and Private Equity

On December 2, 2008, Charlie McCreevy, the European Commissioner for Internal Market and Services, announced he would start a wide-ranging project related to the risks of hedge funds. In the same speech, Commissioner McCreevy also outlined in broad terms the scope of the reviews that the European Commission aims to carry out over the coming months in relation to hedge funds and private equity which "will inevitably lead to a new architecture for financial markets." The principal aim of these initiatives is to allow the Commission to assess the adequacy of measures in place and to identify where strengthened requirements may be necessary.

The EU initiative on hedge funds will focus primarily on the following issues: (1) the definition of hedge funds; (2) how to deal with their usually "offshore" domiciles; (3) who should oversee hedge funds; (4) the transparency of hedge fund vehicles, both to regulators and to the market; (5) short-selling and whether or not it should be banned; and (6) risk management practices of hedge funds. Commissioner McCreevy stated that "the most important concrete input I want is on the contagion and systemic risks to the financial markets if we were to continue to rely on the existing regulatory framework surrounding hedge funds and banks".

In relation to private equity, Commissioner McCreevy considers that the private equity industry "is moving in the right direction" in relation to improving transparency and corporate governance and he stated that it did not "pose any significant risk to financial stability." While acknowledging that private equity played a very different role to that of hedge funds, Commissioner McCreevy continued to state that numerous private equity deals had been over-leveraged and that he will present a review to the European Parliament before the end of February 2009 in relation to the codes currently applied across the private equity industry to ensure that they are subject to effective monitoring.

## Private Investment Funds Practice

Our Private Investment Funds Group comprises more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity, hedge and other alternative investment funds and their managers, including structuring investment vehicles of all types, portfolio company investments, institutional investor representation and secondary purchases and sales.

This newsletter for clients of our Private Investment Funds Practice discusses recent developments affecting hedge funds and private equity funds.

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