PROSKAUER ROSE LLP

Private Investment Funds

Update

OCTOBER 2008

In this issue:

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The unprecedented conditions in financial markets recently have led to unprecedented government intervention globally, most notably the adoption by the U.S. Congress of the Troubled Asset Relief Program granting the Secretary of the Treasury extensive power to invest in and buy troubled assets from banks. Legislators and regulators globally have called for more extensive regulation of financial institutions, particularly hedge funds, and for closer coordination among regulators internationally, and for greater oversight of many of the markets in which hedge funds trade. This edition of our Private Investment Funds Update summarizes some of the recent developments that have the greatest potential impact on hedge funds, private equity funds and other alternative investment funds.

New Short Sale Restrictions and Reporting

U.S.

On October 14, 2008 and October 15, 2008, the Securities and Exchange Commission adopted rules that continue the emergency orders issued by the SEC on September 17, 2008 and September 18, 2008. The new rules include (i) a rule that mandates persons filing Form 13Fs to report their short positions, (ii) a rule requiring the closing out of "failures to deliver" securities, and (iii) a rule concerning deception of market participants about a seller's intention to deliver securities at settlement. The reporting rule and the close-out rule contain changes from the previous emergency orders. The anti-deception rule is substantially similar to the emergency orders.

The short sale reporting rule, which is effective until August 1, 2009, requires any person that files a Form 13F for the relevant calendar quarter, to file a Form SH on a weekly basis. The SEC revised the rule included in the emergency orders to, among other things, (i) change the due date of the form, (ii) change the de minimis exception and (iii) eliminate the grandfather provision for short positions entered into prior to September 22, 2008. The Form SH filing must now be made on the last business day of each calendar week immediately following the calendar week in which any new short positions with respect to Section 13(f) securities were effected. The revised reporting rule increases the "de minimis" exception to $10 million in market value and 0.25 percent of the issued and outstanding Section 13(f) securities. Reporting persons must also now include short positions that existed prior to September 22, 2008. There is an optional two-week phase-in period for reporting pre-September 22 short positions. If a filing person takes advantage of the phase-in period by excluding pre-September 22 short positions from its Form SH report to be filed on October 24, 2008, and/or October 31, 2008, the lower de minimis exception threshold of $1 million in market value and 0.25 percent of the issued and outstanding class of the relevant 13(f) securities continues to apply for the phase-in period.

Further SEC guidance on the disclosure of short sales can be found at http://www.sec.gov/divisions/marketreg/shortsaledisclosurefaq.htm.

UK

On September 19, 2008 the UK Financial Services Authority (the "FSA") prohibited temporarily the short-selling of shares of certain UK financial sector companies and introduced new disclosure requirements for net short positions in UK financial sector companies. The new provisions are due to end on January 16, 2009.

Under the provisions, a person is prohibited from entering into a transaction that, whether by itself or in conjunction with other transactions, has the effect of "creating a net short position in a UK financial sector company" or "increasing any net short position in a UK financial sector company that the person had immediately before 19 September 2008" (this prohibition extends to intra-day trading). The new ongoing disclosure requirements relate to a net short position which represents an economic interest of 0.25% or more of the issued capital of a UK financial sector company. Those holding disclosable net short positions are expected to disclose their positions by 15:30 on the business day following each day on which the disclosable short position is held.

The FSA has indicated that there is a strong possibility of further action being taken in relation to short-selling, confirming that it planned to publish a "comprehensive review on the rules of short-selling" in January 2009.

France

The French financial regulator, the Autorité des Marchés Financiers (the "AMF"), issued a press release on September 19, 2008, followed by another one on September 22, 2008, announcing a ban on short positions in the securities of 15 companies listed on the Euronext Paris stock exchange.

The new regulation applies to transactions made on one's own account or on behalf of third parties, including spot, forward and option transactions, and does not apply to transactions made by investment service providers acting as market makers, liquidity providers or as counterparties for block trades in equities. The new regulation is mostly targeted at the banking and insurance industries.

These provisions came into force on September 22, 2008 for a period of at least three months. At the end of the period, the AMF will decide which measures, particularly those relating to the transparency of short-selling transactions, shall remain in force.

Other similar actions have been taken in other countries.

No New Deferred Fees After December 31, 2008

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 prohibits deferred compensation from “nonqualified entities” with respect to services performed after December 31, 2008, and requires that all existing deferred compensation from non-qualified entities be realized before 2018.

Because of this change, 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, the deadline for all existing deferred compensation arrangements to be brought into compliance with Code Section 409A. In addition, hedge fund managers should generally analyze 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.

Some have questioned whether the new statute prohibits re-deferral of existing deferred fees. Although the new statute prohibits deferring compensation for services performed after December 31, 2008, it does not address specifically whether it is permissible to re-defer deferrals of amounts attributable to pre-January 1, 2009 service. It should also be noted that these new prohibitions do not affect equity interests, and as a result do not affect "carried interest" received by private equity and certain hedge fund managers that is structured as a partnership profits interest.

New Form 5500 Requirements for U.S. Plans

New reporting and disclosure rules for ERISA investors may impact the information that private investment funds must collect and provide to those investors. The Department of Labor ("DOL") recently issued some long-awaited clarifications to these rules that distinguish between different types of private funds that are not holding plan assets.

By way of background, ERISA plans are generally required to file an annual report known as Form 5500. As a result of a regulation issued in November 2007, Schedule C to Form 5500 now requires that the plan disclose compensation (of at least $5,000) paid to any service provider to the plan. The 2007 regulation provided that this applied whether the compensation or the service was paid or provided directly or indirectly. Under this rule, compensation paid to a service provider by a private investment fund was reportable by the plan regardless of whether the investment fund was holding plan assets.

As a result of some recently released FAQs from the DOL, this reporting requirement changed, but only for certain types of funds. Specifically, the FAQs provide that compensation received in connection with the management or operation of an operating company (VCOC or REOC) is not reportable.

In contrast, compensation received in connection with investment funds that are not holding plan assets but are also not operating companies (such as private funds operating under the 25% limit and mutual funds) remain subject to these reporting requirements. While there is generally an exception for ordinary operating expenses (such as brokerage costs to effect securities transactions, accountant/attorney fees, etc.), other compensation (such as placement agent fees, management fees and performance fees paid to the manager) likely will be reportable (although simplified methods could apply if certain disclosures are made). Disclosure of compensation such as director's fees and breakup fees also may need to be disclosed if these fees do not offset the management fee.

Private Fund Valuation by ERISA Plans

Typically, administrators of ERISA plans rely upon the valuation information provided by the general partners of private funds for purposes of valuing the plan's interest in the fund. A recent letter from the Boston office of the Department of Labor, however, has indicated that doing so may constitute a breach of fiduciary duty under ERISA.

The DOL's Boston office indicated that relying only on unaudited financial information provided by a private fund or its general partner or advisor may not be sufficient. The Boston office has told a plan's fiduciaries that they potentially breached their fiduciary duties by not having an established process by which the fair market value of alternative investments could be determined. The Boston office further stated that the fiduciaries need to have "a complete understanding of the underlying investments and the fund's investment strategy," and "a thorough knowledge of the general partner's valuation methodology to assure it comports with the fund's written valuation provisions and reflects fair market value."

SEC Loosens Mark-to-Market Rules

The Office of the Chief Accountant of the SEC has provided clarification regarding the mark-to-market rules reflected in FASB Statement 157. Highlights of the release include:

- When an "active market" does not exist, internal assumptions may be used when measuring fair value. Unfortunately the SEC did not define what "active market" means. The SEC did, however, state that a significant increase in the spread between "ask" and "bid" prices and/or the presence of a small number of bidders are factors suggesting an inactive market.
- Forced liquidation sales are not determinative when deciding fair value. A transaction value has more weight when the buy-sale is conducted in an "orderly" manner.

The SEC has announced that a roundtable discussion will be held on October 29, 2008, to discuss mark-to-market accounting. This roundtable is part of the SEC's requirement to study, with the Treasury, mark-to-market accounting under Statement 157 and its role in the credit freeze, and report to Congress in January, 2009. A copy of the SEC's press release can be found at http://www.sec.gov/news/press/2008/2008-234.htm.

Aftermath of Lehman Brothers Failure

The consequences of the failure of Lehman Brothers continue to be felt throughout the financial system, including:

- Customers of Lehman Brothers Inc. ("LBI") in the United States generally have not had access to their assets held at LBI since September 15, 2008, due to the blockage of all assets of LBI held at Depository Trust & Clearing Corporation. It is expected that customer assets held at LBI will be released shortly.
- Customers of Lehman Brothers International (Europe) ("LBIE") in the United Kingdom have not had access to their assets since September 15, 2008 due to the appointment of an administrator for all assets of LBIE. Customers of LBIE also face the prospect of losing their preferred status as customers and instead being treated as general creditors with respect to any assets that were rehypothecated by LBIE. It is not clear when assets held at LBIE will be released.
- Counterparties dealing with various Lehman-related affiliates face losses on swaps, forwards and other derivatives.

We can provide more detailed explanations of these and other developments triggered by the Lehman Brothers collapse. We can also assist hedge funds and other investors in evaluating all of their custody and counterparty arrangements and exposures.

The Fed Expands Ability of Private Funds to Invest in Bank Holding Companies

The Federal Reserve has issued a new policy statement that expands the ability of private equity funds, hedge funds, and other investors to make more significant investments in banks without being subject to regulation under the Bank Holding Company Act of 1956 (the "BHC Act").

The new policy allows investors to make the following types of investments without being subject to regulation as bank holding companies under the BHC Act:

- Voting stock ownership is now allowed up to 14.9% of the total outstanding voting shares. The old rules only allowed ownership up to 9.9%.
- Investors are allowed to appoint up to two directors under certain conditions, instead of the one director previously allowed.
- Investors may talk to management about the policies and operations, provided that the board, management and shareholders retain ultimate decision-making authority.

Courts Interpret Material Adverse Change Clause

In a number of recent cases, courts have been asked to determine the enforceability of "material adverse change" clauses in acquisitions agreements. A Delaware Chancery Court, for example, found that a portfolio company of Apollo Management LP, Hexion Specialty Chemicals Inc., must perform its covenants in a merger agreement with Huntsman Corp. The judge disagreed with Hexion's claim that Huntsman had suffered a material adverse effect that voided the deal. The judge noted that deterioration of general economic conditions did not give rise to a material adverse effect under the terms of the negotiated merger agreement.

The judge also concluded that Hexion knowingly and intentionally violated the merger agreement by failing to use its reasonable best efforts to proceed with the transaction. This finding exposes Hexion to damages above and beyond the $325 million breakup fee if the deal is not completed.

The Delaware court left open the question of whether Apollo could be held liable for any damages.

Automatic Stay Protects a Limited Partner in Bankruptcy

When a limited partner files for relief under the United States Bankruptcy Code, the limited partner obtains the benefits of the “automatic stay” under the Code. The automatic stay is a statutory injunction that broadly enjoins parties from taking actions and exercising remedies against the entity that filed for bankruptcy protection, or any of its property, wherever located. The stay goes into effect automatically upon the filing by the limited partner; no court action is necessary.

A limited partner in a private fund subject to capital calls may be in default under the partnership agreement either prior to, or as a consequence of, the bankruptcy filing. In either case, partnership agreements generally vest general partners with powers to address problems with defaulting partners. For instance, the general partner may have the right to exercise remedies to collect on capital calls, limit the defaulting partners’ voting rights, or otherwise affect, and perhaps even divest, the limited partner of its limited partnership interest in the fund. General partners should be aware that exercising these rights, and perhaps even the mere sending of notice of its intent to exercise these rights, might be prohibited by the automatic stay.

A court could order damages and other sanctions for violations of the automatic stay. Therefore, before exercising rights against a defaulting limited partner that has filed for bankruptcy protection, it is prudent to consult with an insolvency practitioner who can guide you on how to obtain relief from the automatic stay.

Recent IRS Revenue Rulings

Three recent Internal Revenue Service (“IRS”) revenue rulings have limited the availability of the deduction of interest expense and management fees for U.S. individual investors in hedge funds and hedge fund-of-funds.

Interest

In the first ruling, Revenue Ruling 2008-12, the IRS held that if a partnership such as a hedge fund was engaged solely in the trading of stocks and securities for its own account and incurred indebtedness in its trading activities, then a noncorporate limited partner that did not materially participate in the partnership’s activities would be subject to the limitations on deduction of investment interest under the Internal Revenue Code (the “Code”) with respect to its distributive share of the partnership’s interest expense.

By way of background, a noncorporate taxpayer may deduct investment interest in any tax year, but only to the extent of its net investment income for the year. Section 163 of the Code defines investment interest as interest that is paid or accrued on indebtedness properly allocable to property held for investment. Property held for investment includes any interest held by a taxpayer in an activity involving the conduct of a trade or business that is not a passive activity and with respect to which the taxpayer does not materially participate, including any activity conducted through a partnership.

The ruling concludes that because the limited partner did not materially participate in the partnership's trading activities, the limited partner's interest in such activities would be treated as property held for investment. Accordingly, the limited partner's distributive share of the partnership's interest expense was treated as investment interest subject to the investment interest limitation. The ruling also provided that the partnership was required to separately state its interest expense (and not simply net it against its income for tax reporting purposes) since the degree of participation by a noncorporate partner could affect the characterization of the interest expense incurred by the partnership as investment interest.

The second ruling, Revenue Ruling 2008-38, elaborates on the application of the investment interest limitation for U.S. individual investors in hedge funds that incur indebtedness in their trading activities. The IRS also issued Announcement 2008-65 to clarify the guidance given in Revenue Ruling 2008-38 regarding the proper reporting of the interest expense on an individual's federal income tax return.

Ruling 2008-38 provides that, in the case of an individual limited partner, interest paid or accrued on indebtedness allocable to property held for investment is, to the extent allowable after the application of the investment interest limitation, a deduction taken into account in determining the individual's adjusted gross income. The IRS also clarified the treatment of an individual that has both investment interest expense attributable to (1) indebtedness allocable to property that is held in the conduct of a trade or business, which is not a passive activity and in which the taxpayer does not materially participate, and (2) property that produces income that is not passive income under Section 469(e)(1) of the Code (for example, interest and dividends). The IRS ruled that the income attributable to these two categories must be allocated based on a reasonable method.

Management Fees

The third ruling, Revenue Ruling 2008-39, which relates to limited partners in fund-of-fund structures, addresses a limited partner's ability to deduct management fees incurred by an upper-tier partnership ("UTP"). Under the ruling, an UTP owned limited partnership interests in several lower tier partnership ("LTPs"), which were engaged in the trade or business of trading stocks and securities. The UTP's activities consisted solely of acquiring, holding, and disposing of interests in these LTPs.

The ruling concludes that the UTP's management fee is not an ordinary and necessary business expense deductible by the UTP under Code Section 162, but rather is a separately stated item that is passed through to its limited partners and is deductible by them as an expense incurred for the production of income under Code Section 212. Expenses deductible under Section 212 are subject to a 2% floor and other limitations on itemized deductions, with the result that these expenses often are unavailable to individual limited partners. Thus, under the ruling, the trading activities of LTPs are not attributed to an UTP or its limited partners.

The ruling also provides that the LTP's management fee is deductible as a Section 162 expense and reduces the income allocated to an UTP that is then allocated to the UTP's limited partners. Accordingly, the management fees of the LTP are not subject to the 2% floor or other limitations on itemized deductions.

Although not addressed in the ruling, its treatment of UTP management fees as a Section 212 expense could adversely affect the typical master-feeder structure, where management fees are imposed at the feeder or UTP level. In that case, the rationale of the ruling could require U.S. individual investors to treat the management fees as a Section 212 expense.

New Annual Reporting Regime for BVI Funds

The British Virgin Islands Financial Services Commission announced new annual reporting requirements for all British Virgin Islands ("BVI") private, professional and public funds. The new reporting is expected to become mandatory for the year ending December 31, 2008.

Each such fund will be required to report summary financial information for the relevant reporting period, which includes beginning net asset values, total subscriptions, total redemptions, net income/net loss, dividends/distributions, ending net asset values and year-end gross assets.

Funds will be required to submit Annual Returns within six months of the end of each reporting period.

Potential New Regulations

Treasury Secretary Henry Paulson, SEC Commissioner Cox and various members of Congress and foreign leaders have blamed a lack of oversight and regulation of financial markets for subprime credit problems, the failures of Bear Stearns and Lehman Brothers Holdings, the bailouts of AIG and other financial institutions, and the broader crisis in financial markets generally. Congressional hearings have been scheduled to consider the need for further regulation of hedge funds, and Representative Barney Frank has called for regulations requiring hedge funds to maintain higher minimum capital levels. Commissioner Cox and others have called for increased regulation of credit default swaps and other products.

On September 23, 2008, the European Parliament issued to the European Commission a resolution with recommendations on private equity and hedge funds. The Parliament's demands include: the application to private equity of capital requirements regulations, increased disclosure and monitoring, changes to compensation structures, limits on leverage, information for and consultation with workers, and criticisms of alleged asset stripping and capital depletion.

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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