Private Investment Funds
Update

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Proskauer Investment Adviser Task Force
In response to legislative proposals introduced this year that, if adopted, would require advisers to most private equity and hedge funds to register with the SEC, Proskauer has formed an Investment Advisers Act "task force" to help our clients understand the legislative proposals and their likely effects on the operation of private funds and prepare for SEC registration and ongoing compliance if and when the proposed legislation is passed.

We have extensive practical experience assisting advisers in becoming registered, developing compliance procedures and programs and preparing and responding to SEC examinations.

Private Fund Investment Advisers Registration Act of 2009

Proposals to require the registration of investment advisers to private funds continue to work their way through Congress. On October 1, 2009, Congressman Paul E. Kanjorski introduced in the House of Representatives the Private Fund Investment Advisers Registration Act of 2009 (the "PFIARA"), which is aimed at regulating hedge funds and private equity funds. Congressman Barney Frank, Chairman of the House Financial Services Committee, intends to hold a meeting this week to mark-up this bill.

The proposed legislation would generally require all advisers to private funds to be registered with the SEC as an investment adviser.

Importantly, the legislation would exempt advisers to "venture capital funds" from the requirement to register and would require the SEC to define the term "venture capital fund." The PFIARA would also exempt "foreign private fund advisers," meaning investment advisers that have no place of business in the United States, do not generally hold themselves out to the public in the United States, have fewer then 15 clients in the United States during the preceding 12 months, and have less than $25 million in assets under management that are attributable to U.S. clients.

House Committee Passes Proposed Legislation of Derivatives

On October 15, 2009, the House Financial Services Committee passed proposed legislation to regulate the over-the-counter derivatives market.

The bill includes many of the themes set forth in the principles stated by Chairman Frank and House Agriculture Committee Chairman Colin Peterson in July. The Financial Services Committee has jurisdiction over the federal banking regulators and the SEC while the Agriculture Committee has jurisdiction over the CFTC. The proposal also closely follows the bill offered by Treasury Secretary Timothy Geithner and CFTC Chairman Gary Gensler earlier this year.

Pursuant to the bill, derivatives would be exempt from centralized clearing if "one of the counterparties to the transaction is not a swap dealer or major swap participant." It is important to note however, that such swaps would still be required to be reported to regulators. This exemption would exclude many end-users of swaps, such as firms that use derivatives to hedge their operations, from some requirements to post cash margin in connection with derivatives.

The bill defines a swap dealer as "any person engaged in the business of buying and selling swaps for such person's own account, through a broker or otherwise," but exempts from the definition of swap dealer any entity that "buys or sells swaps for its own account, either individually or in a fiduciary capacity, but not as a part of a regular business." This compares with the Treasury's proposed definition of swap dealer, which captured market participants who use swaps for hedging, if their hedging activity does not qualify as hedging under Generally Accepted Accounting Principles ("GAAP").

The Frank proposal defines a major swap participant as an entity "who is not a swap dealer" but who has a "substantial net position" in outstanding swaps, excluding positions held primarily for hedging (including balance sheet hedging) or risk management purposes.

Major swap participants are defined more narrowly in the House bill than in the Treasury proposal, as the Treasury definition of major swap participants include end-users whose hedging activities do not qualify as hedging under GAAP. Although the bill excludes a broader range of end-users from regulation than the Treasury proposal, by excluding end-users that use swaps for hedging purposes, whether or not the hedging qualifies under GAAP, the bill's definition of major swap participant may capture at least some hedge funds and investments advisers that invest in swaps for purposes other than hedging, as did the Treasury proposal.

Under the House bill, the SEC and CFTC would also be given the authority to "prohibit transactions in any swap" that they determine "would be detrimental to the stability of a financial market or of participants in a financial market." The CFTC would also be given authority to regulate certain foreign boards of trade offering access to U.S. investors on any linked "agreement, contract or transaction," whereby the foreign boards of trade would be required to release trading data, establish rules to prevent market manipulation and excessive speculation and set position limits.

Restructuring Incentive Fee Compensation Payable by an Offshore Fund

In 2008, the U.S. government eliminated the ability of U.S. managers of offshore funds to defer fees. Managers that have not yet restructured incentive fees into incentive allocations should consider taking such action with respect to 2010 incentive fees. Generally, under a restructuring, the offshore fund would conduct its investment program indirectly by investing its assets in an offshore limited partnership or in an offshore corporation that elects to be treated as a partnership for U.S. federal income tax purposes, and the manager would receive an allocation of a portion of the partnership's profits.

To the extent that the incentive allocation represents long-term capital gains, such amount would be taxed at the lower long term capital gains rate. The potential tax benefits will be greater for managers whose investment programs produce a significant amount of long term capital gains than for other managers.

Managers with side pocket arrangements with offshore funds that pay incentive fees only on realized gains in the side pocket should also analyze whether amendments are required in order to avoid impostion of the excise tax imposed by Section 457A of the tax code.

ILPA Private Equity Principles

The Institutional Limited Partners Association, a trade association representing over 215 institutional investors in private equity with approximately $1 trillion in private equity assets under management, recently published its "Private Equity Principles." According to the ILPA, the goal of the Private Equity Principles is to strengthen the long-term viability of the asset class as an institutional investment strategy through (i) aligning interests between general partners and limited partners, (ii) enhanced partnership governance and (iii) improved investor reporting and transparency.

The ILPA acknowledges that the typical "80/20" profit split has worked well to align partner interests. However, the proposed guidelines call for economic changes to other terms, including: the receipt by limited partners of all contributions plus a preferred return before the general partner receives any carried interest distributions; clawback determinations at the end of every reporting period and the satisfaction of any clawback liabilities (gross of taxes) within two years following recognition of such liabilities; carry escrow accounts of at least 30% of carried interest distributions and joint and several clawback liability for carried interest recipients; management fees that are based on reasonable operating expenses and salaries; and 100% of portfolio company generated fees accruing to the benefit of the partnership.

With respect to governance, the Private Equity Principles promote: the avoidance of provisions that allow a general partner to reduce its fiduciary duties; requiring the general partner to present all conflicts to the limited partner advisory committee; avoiding "style drift" by clearly and narrowly identifying the investment strategy; a no-fault termination of the investment period by a majority in interest of the limited partners; and a no-fault removal of the general partner or dissolution of the partnership by at least two-thirds in interest of the limited partners.

The ILPA states that the Private Equity Principles are intended to serve as an "educational medium" and it is not seeking the commitment of any private equity investor to any of the outlined terms. However, the ILPA is encouraging members and non-members to endorse the principles. The ILPA has listed on its website those limited partners, general partners and industry consultants who have endorsed the principles. A copy of the ILPA Private Equity Principles can be found at http://www.ilpa.org.

Update on the Proposed EU Directive on Alternative Investment Fund Managers (the "Directive")

There have been a number of significant developments since publication of the Directive in April 2009:

- The Swedish Presidency circulated an Issues Note in September, identifying key issues about the Directive such as consistency and interaction with existing EU directives, scope, requirements relating to valuation, custody, delegation and leverage, and third country issues, and suggesting options to reach a compromise within the European Council.
- Institutional investors have joined fund managers in criticising the Directive. A group of eight Dutch pension funds wrote to the EU's Internal Markets Commissioner, Charlie McCreevy, arguing that the proposals would reduce investment options available to investors, reduce risk diversification, and lead to higher costs and lower investment returns for investors. The UK's National Association of Pension Funds has sent a similar letter.
- In the UK, the Financial Services Authority (FSA) has expressed its general support for the Directive but identified certain areas of concern, such as differentiation between types of funds, the scope of the proposals, and the need for a more risk-based approach to leverage rather than imposing arbitrary caps. The FSA disagrees with the requirement to appoint only EU credit institutions as custodians, restrictions on

delegation to non-EU entities in relation to management, custody and depositary services, and outright prohibitions on the marketing of non-European funds to professional investors.

- The FSA published a study by Charles River Associates in October, which estimated that the Directive will impose one-off compliance costs of up to €3.2bn on fund managers (AIFMs), and ongoing compliance costs of around €311m per year, which they believed would be passed onto investors, leading to reduced returns. Open Europe, an independent think-tank, issued a report in September, based on a survey of members of the AIMA and BVCA, which estimated compliance costs in the first year of up to €1.9bn, and ongoing compliance costs of up to €985m per year.
- Intensive debates involve the Directive's potential impact on the ability of non-EU AIFMs to market their funds within the EU. Under the current draft, a non-EU AIFM must meet five conditions to market a fund in the EU: its home country must have equivalent prudential regulation and supervision, offer effective market access to EU fund managers, have supervision and tax information agreements with EU regulators, and the AIFM must disclose the identities of significant owners of the fund. As a result, there is a real risk that non-EU AIFMs might be banned from marketing to investors in the EU unless they establish an office in the EU and subject themselves to EU and member state regulations. Further, the proposals might trigger non-EU countries to implement reciprocal lock-out initiatives against EU fund managers. Industry representatives and government officials, however, have expressed cautious optimism of possible material changes to the current wording of the Directive.
- Discussions on the Directive have begun in the European Parliament. The process of approving the Directive in the European Parliament and European Council is expected to take 6-12 months. If approved, the EU Commission would work with European national regulators to develop standards to ensure consistent implementation and application of the legislation, then the EU member states would need to ratify the legislation into national laws within a given deadline.

We will continue to monitor the progress of the Directive.

New SEC Privacy Regulation S-AM

The SEC recently adopted Regulation S-AM, which addresses affiliate marketing through the use of consumer information. Regulation S-AM is designed to prevent registered investment advisers, investment companies, broker-dealers and registered transfer agents ("Covered Firms") from using certain consumer information provided by a Covered Firm's affiliate to market products, unless there is disclosure to the consumer and the consumer does not "opt out" of such marketing. Compliance with Regulation S-AM will be required by January 1, 2010.

Regulation S-AM provides that Covered Firms may not use "eligibility information" (defined below) about a consumer obtained from relationships with affiliates to solicit the consumer, unless:

- the consumer is provided a reasonable method and opportunity to “opt out” of the use of such information for marketing purposes;
- the consumer does not opt out; and
- the consumer receives a clear, conspicuous and concise disclosure notice that the Covered Firm may use such eligibility information.

“Eligibility Information” is defined broadly and includes personally identifiable information obtained as a result of a relationship with an affiliate.

Regulation S-AM provides for several exemptions from the notice and opt-out requirements, including:

- Covered Firms responding to consumer-initiated communications about products or services;
- Covered Firms responding to authorizations by the consumer to receive solicitations; and
- Solicitations to consumers who have a pre-existing business relationship (such as an investment advisory contract) with a Covered Firm.

In these cases, the Covered Firm can use eligibility information from affiliates to solicit its services without a notice or opt-out provision.

The SEC stated that the notice and opt-out provisions of Regulation S-AM may be combined with other similar disclosures, such as Regulation S-P’s requirement to notify clients of an adviser’s privacy policy upon becoming a client and annually thereafter. Managers should consider if any updates need to be made to their Regulation S-P policies, however, if private fund managers do not share information with affiliates these new requirements are not applicable.

The text of the final rule, including model notice forms, is available at http://www.sec.gov/rules/final/2009/34-60423.pdf.

SEC’s Director of Enforcement Announces New Initiatives

Robert Khuzami, the Director of the SEC Division of Enforcement, recently outlined various steps taken to improve the Division of Enforcement. These new initiatives include:

- Increased use of the SEC’s subpoena power;
- Creation of specialized units dedicated to specific areas of securities law;
- Creation of a new Office of Market Intelligence to collect and analyze tips and complaints that the SEC receives; and
- Increasing incentives to individuals to cooperate in SEC investigations.

These announcements perhaps anticipate other recent developments, such as the bringing of criminal insider trading charges late last week against the head of Galleon, a large hedge fund. We have also noted a significant increase in SEC enforcement actions involving technical violations of the prohibition in Rule 105 of Regulation M against buying a security in a registered offering within five business days after selling short the same security.

Subpoenas

The new policy allows the SEC's Enforcement Division staff to obtain subpoenas from their supervisors instead of the full five-member Commission.

Specialized Teams

The SEC plans to create five new teams dedicated to particular areas of law. These include:

- Market Abuses, focused on large-scale market abuses.
- Structured Products, focused on complex derivatives and financial products.
- Asset Management, focused on investment advisers, hedge funds and private equity funds.
- Municipal Securities and Public Pensions, focused on "pay-to-play" schemes.
- Foreign Corrupt Practices, focused on new approaches to identify violations of the Foreign Corrupt Practice Act.

Increase Number of Front-Line Attorneys

The SEC is "flattening" its management structure and adding to the ranks of its Trial Unit in order to clearly indicate to defendants that the SEC will go to trial.

Encouraging Cooperation by Individuals

The Enforcement Division will increase its incentives to encourage people to testify in SEC cases without fear of criminal prosecution or civil charges. The SEC is seeking an expedited process for immunity requests.

SEC Ramping Up Enforcement of Schedule 13D Filings

On July 21, 2009, the SEC instituted an administrative proceeding against Perry Corp. (an investment adviser) for not filing a disclosure statement on Schedule 13D pursuant to Section 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act") within 10 days of acquiring more than 5% of the common stock of Mylan Laboratories, Inc. This case is significant because it demonstrates that the SEC is ramping up oversight of disclosure and filing obligations by private funds.

Mylan announced on July 26, 2004, an agreement to acquire King Pharmaceuticals, Inc. that was subject to approval of shareholders. At the time of the announcement, Perry held 4.3 million shares of King. After the merger announcement, Perry began short-selling Mylan shares (and maintained its King position) in order to take advantage of an arbitrage opportunity. The merger agreement contemplated that upon completion of the merger, Perry's King shares would be converted into shares of Mylan, which Perry could use to cover its short sales.

On September 7, Carl Icahn filed a Schedule 13D stating that he had acquired 6.8% of Mylan's outstanding shares and that he opposed the Mylan-King merger and intended to solicit proxies against the merger. Perry then acquired voting power over 26.6 million (or 9.89%) of Mylan's shares to vote in favor of the merger. Voting power over approximately 21 million of these shares came from swap transactions that gave Perry voting rights. By the close of business on September 24, 2004, Perry had acquired voting power over 16.2 million Mylan shares, representing more than 5% of outsanding shares, and was thereby required to file a Schedule 13D stating its voting intentions with respect to those shares pursuant to Section 13(d) of the Exchange Act within 10 days absent an exemption.

Rule 13d-1(b) of the Exchange Act allows certain qualified institutional investors, and persons registered as investment advisers, to file a short-form statement on Schedule 13G within 45 days after the end of the calendar year in which they make an acquisition that crosses the 5% threshold, if the investor purchases the securities in the "ordinary course" of its business and not with the purpose of changing or influencing the control of the issuer.

However, the SEC believed that the entire purpose of Perry's transactions was to acquire voting rights to Mylan shares for the purpose of voting the shares in the merger. The SEC stated that the exception to the ordinary 10-day disclosure requirement is available only where investors are acquiring securities for passive investment or ordinary market making purposes. When an institutional investor acquires securities or an interest in securities with the purpose of influencing the management or direction of an issuer or to influence the outcome of a transaction, then such securities are not held in the ordinary course of business for purposes of Rule 13d-1(b). This proceeding indicates that the SEC may be cracking down on fund managers that pursue an activist strategy, but fail to file Exchange Act disclosure documents.

SEC Comment Period for Uptick Rule Closed

The comment period for a SEC proposal to limit short sales through a price test alternative has ended. Price tests limit short sales from occurring unless the sale price equals or exceeds a reference price.

In an April 2009 proposal, the SEC sought comment on a bid test (the modified uptick rule) based on the current national best bid for a security, and a last sale test (the uptick rule) based on the last reported transaction price for the security. The SEC also proposed three versions of "circuit breakers" that would impose short selling restrictions following a severe decline in the market price of a particular security. The SEC later sought comment on a new and significantly more restrictive "alternative uptick rule" that would allow short selling only at a price above the current national best bid.

The alternative uptick rule would be similar to the SEC's proposed modified uptick rule in that both would use the current national best bid as a reference. However, unlike the modified uptick rule, the alternative uptick rule would not permit short selling at the current national best bid. Rather, the alternative uptick rule would require short sellers to offer price improvement over the best prices available and would permit short sales only at an increment above the national best bid. Therefore, it would prohibit immediate execution of a short sale, even in an advancing market, and restrict short selling to a greater extent than would either the modified uptick rule or the uptick rule.

Based on comments received on its April 2009 proposal, the SEC appears to believe that the alternative uptick rule might be easier to implement than the modified uptick rule or the uptick rule. For example, the alternative uptick rule would not require a determination as to whether the current national best bid or last sale price is above or below the previous national best bid or last sale price.

The alternative uptick rule could be implemented using policies and procedures or new rules. In addition, like the modified uptick rule and the uptick rule, the alternative uptick rule could be implemented in conjunction with a circuit breaker rule.

Massachusetts Proposes Amendments to Information Security Program Regulations and Compliance Deadline

On August 17, 2009, the Massachusetts Office of Consumer Affairs and Business Regulation published for comment proposed amendments to the regulations that require persons (including funds) who own or license personal information about a Massachusetts resident, such as a shareholder or employee, to develop, implement and maintain a comprehensive, written information security program, including a computer security system program. Under the amended regulations, "owns or licenses" is defined to include receiving, processing or otherwise accessing personal information. The deadline for compliance with the proposed amended regulations is March 1, 2010.

New UK Reporting Fund Regime

Effective on December 1, 2009, the United Kingdom will replace the old "distributing fund" tax rules with a new simpler regime called the "reporting fund" regime.

Currently, a typical UK resident individual investing in a typical offshore fund that is not a "distributing fund" under UK tax rules must pay income tax on redemptions at higher rates than capital gains tax. In order to obtain distributing fund status under the present rules, a fund must generally distribute annually at least 85% of any dividend and interest income received by the fund. The top UK marginal rate of income tax (40% today, rising to 50% in April) is much higher than the capital gains tax rate of 18%.

The key difference between the two regimes is that a reporting fund will only be obligated to report its income to investors instead of actually requiring a physical distribution each year. Promoters of offshore funds should analyze their products and their target investor base now to determine whether they can comply with the new rules.

Power of Attorney Law Changes in New York

New York State has amended its power of attorney statute covering powers of attorney executed by individuals on or after September 1, 2009, while located in the State of New York, in several significant respects that are creating problems throughout the financial services industry, including the private fund industry.

The new law, among other things, imposes on the agent certain fiduciary and other duties and a "prudent man" standard of care. In addition, the new law requires that any power of attorney contain verbatim certain specified risk disclosures, be of clear type of no less than 12 point in size, and be signed and notarized by both the principal and the agent in order to be effective. The new law will not affect powers of attorney executed prior to September 1, 2009, or powers of attorney executed by entities (such as a corporation or partnership). However, execution of a power of attorney by an individual on or after September 1, 2009 while in New York will have the effect of revoking all prior powers (including unrelated powers of attorney) granted by that individual, unless specifically stated otherwise in the power itself.

The new law applies to powers of attorney that are typically included in limited partnership agreements and other fund documents, estate planning documents and SEC filings. Clients of Proskauer are urged to contact the firm to discuss the best approach to compliance with the new law.

BVI Extends Deadline for Annual Returns

In September 2008, the BVI Financial Services Commission ("FSC") introduced an annual reporting requirement for all private and public funds.

Each fund must report the following:

- basic governance information, including information on agents and other functionaries; and
- financial information including beginning NAV, total subscriptions, total redemptions, net income/net loss, dividends/distributions, ending NAV and year-end gross assets.

The deadline for filing the report for 2008 has been extended. All funds must file their Annual Returns for the 2008 reporting period by the extended deadline of November 15, 2009.

The FSC has stated that, in the future, funds will generally be required to submit Annual Returns within six months of the end of each reporting period.

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 and hedge 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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