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Private Investment Funds Practice Update

May 2007

This update for clients of our Private Investment Funds Practice summarizes recent developments affecting hedge funds, private equity funds and their managers.

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IRS Adopts Final Rules on Deferred Compensation; Compliance due December 31, 2007

On April 10, 2007, the IRS issued the long-awaited final regulations on non-qualified deferred compensation arrangements under Section 409A of the Internal Revenue Code. All employers, including hedge fund managers with deferred fee arrangements with offshore hedge funds or deferred compensation arrangements with employees, now have until December 31, 2007 to amend their nonqualified deferred compensation plans or agreements to bring them into compliance with Section 409A of the Internal Revenue Code. See our more detailed client advisory at: http://www.proskauer.com/news_publications/client_alerts/content/2007_04_30

The final regulations preserve the relief provided in the proposed regulations for "back-to-back" deferral arrangements. However, the final regulations clarify that the rules addressing back-to-back arrangements apply regardless of whether the deferral arrangement between the individual and the hedge fund manager is actually subject to 409A, as long as each deferral arrangement that is part of the overall back-to-back scheme complies with 409A. The final regulations do not provide relief for so called "reverse" back-to-back arrangements, where payments to individuals providing services to the hedge fund manager are required when payments are made from the hedge fund to the manager under a 409A compliant deferral arrangement between the hedge fund and the manager (*e.g.*, on a termination of the investment management arrangement with the fund). However, the preamble specifically states that the issue is being studied by the IRS. Finally, the final regulations do not address the application of 409A to partnership arrangements and provide no guidance concerning the prohibition against certain off-shore funding arrangements.

Recent Tax Proposals

Two significant tax structures applicable to private investment funds have recently received attention in Congress and in the media. A proposal released by the Senate Finance Committee would cap deferred compensation arrangements at $1,000,000 per year. As initially released, the proposal would appear to apply to any deferral arrangement, including deferred fee arrangements between hedge fund managers and offshore funds.

In addition, over the past several weeks, the possibility of change to the taxation of carried interests, or performance-based incentive allocations, to private equity and hedge fund managers has been raised by at least one member of Congress. Concern has been heightened by a series of recent articles in major news publications critical of the tax rules applicable to private investment fund managers.

Although Congressional staff members, including staff members of the Joint Committee on Taxation, are reviewing the tax laws applicable to private investment funds (including the taxation of carried interest), this review is in a preliminary, information-gathering, stage. No legislation has been proposed or drafted, and no decision has been made to implement any change in this area.

We have been actively engaged in the legislative process on behalf of an industry association, and we are continuing to monitor this situation as well as any other legislative action that could impact the private equity and hedge fund industries.

Final IRS Regulations on Portfolio Interest Paid to Partnerships

On April 12, 2007, the Department of the Treasury issued final regulations under Sections 871 and 881 of the Internal Revenue Code clarifying the application of the "portfolio interest" exemption to interest income earned by partnerships. The final regulations clarify that the "10-percent shareholder" test is applied at the partner level, not at the partnership level. This is a favorable result for investment partnerships that make debt and equity investments in portfolio companies. The final regulations are in substantially the same form as the proposed regulations that were issued on June 13, 2006. See our client advisory at http://www.proskauer.com/news_publications/client_alerts/content/2007_04_17

Pending SEC Anti-Fraud and Accredited Natural Person Rules

Two new rules proposed by the SEC on December 13, 2006 remain pending. See our client advisory at http://www.proskauer.com/news_publications/newsletters/PrivateEquity/2007_01_09. The first proposal would create a new antifraud rule pursuant to the Investment Advisers Act of 1940 that would create liability for any false or misleading statements made by an investment adviser to investors or prospective investors in any "pooled investment vehicle," which is defined to include most hedge funds and private equity funds.

The second rule proposal would define a new category of "accredited investor" that would apply to offers and sales to natural persons of securities of a fund relying on the exemption under Section 3(c)(1) of the Investment Company Act of 1940. The new definition would require a natural person to meet the current $1,000,000 net worth or $200,000 ($300,000 with spouse) annual income test, and also to own at least $2,500,000 in "investments" as defined in the proposed rule. The new rule is intended to reduce the number of natural persons eligible to invest in private funds.

Although the SEC has received significant comments on both rules, it is likely that both will be adopted in some form later this year.

Pending Amendments to SEC Short Sale Rules

Also still pending before the SEC are two rule proposals issued late last year relating to short sales. The first proposal would eliminate the up-tick rule in Rule 10a-1 under the Securities Exchange Act of 1934. The proposed amendment would make permanent a temporary suspension of the rule for certain securities under a trial program beginning in 2004. See the proposal at: http://www.sec.gov/rules/proposed/2006/34-54891.pdf

The second proposal would amend Rule 105 of Regulation M to make clear that a person who sells a security short within five days prior to pricing of a public offering, or during the period from filing of a registration statement until pricing, may not purchase the security in the offering, or enter into a contract of sale for such security in the offering. See the proposal at: http://www.sec.gov/rules/proposed/2006/34-54888.pdf

CFTC Requires Electronic Filing of Exemptions

Effective February 15, 2007, notices of exemption from registration under CFTC Rules 4.5, 4.7, 4.12, 4.13 and 4.14 must be filed electronically through the National Futures Association. Previously filed hard copy notices of exemptions have been transferred to the new system and do not need to be re-filed.

A hedge fund manager that wishes to trade futures and take advantage of the exemptions from registration as a commodity pool operator under CFTC Rules 4.13(a)(3) or (a)(4) must now file for the exemption by logging on to: http://www.nfa.futures.org/compliance/ExemptLoginSelection.asp. Managers can view previously filed exemptions online by creating an online account with the NFA.

CFTC Amends Advertising Rules

The CFTC effective March 26, 2007 adopted final amendments to Rule 4.41 regulating advertisements by registered commodity pool operators and commodity trading advisors. See the final amendments at: http://www.cftc.gov/foia/fedreg07/foi070223a.htm. The amendments restrict the use of third party testimonials in advertisements, and specify where certain disclaimers must be placed relating to simulated or hypothetical performance.

Proposed New Privacy Notice

The SEC, CFTC, Department of the Treasury, Federal Trade Commission and other regulatory agencies recently proposed a simplified form of privacy notice that, if adopted, could be used by all financial institutions, including private equity and hedge fund managers. The proposed form can be reviewed at http://www.sec.gov/rules/proposed/2007/34-55497.pdf. If adopted, use of the new form would be deemed to comply with existing rules, but certain previously applicable safe harbors would be eliminated and existing policies would need to be revised.

New Clayton Act and Hart-Scott-Rodino Reporting Thresholds

The Federal Trade Commission effective on January 22, 2007 announced its annual changes in the two threshold figures that define when it is unlawful under Section 8 of the Clayton Act for an individual to serve as an officer or director of two or more competing corporations. These annual changes occur as a result of indexing that is now required by Section 8(a)(5) of the Clayton Act. Under the new thresholds, interlocking management is prohibited, with minor exceptions, if each of the competing companies has capital, surplus and undivided profits in excess of $24,001,000, unless the competitive sales of either of the companies is less than $2,400,100. The thresholds are adjusted based on the change in the Gross National Product.

Effective February 21, 2007, the notification thresholds under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 were also increased. As a result, the basic notification threshold for all transactions required to be reported will be increased from $56.7 million to $59.8 million.

Bankruptcy Court Rulings Require Disclosure of Debt Positions

In a recent ruling in the Northwest Airlines Corporation bankruptcy proceedings, the United States Bankruptcy Court for the Southern District of New York entered two orders requiring an ad hoc committee of Northwest equity security holders to file a supplemental statement of equity and claim holdings pursuant to Bankruptcy Rule 2019 to disclose, among other things, each ad hoc committee member's debt and equity holdings, the dates of all acquisitions, and the amounts paid for such acquisitions. Subsequent to filing an appeal to the two Northwestern rulings, the objecting bondholders decided to disclose the requested information. However, in mid-April, the Bankruptcy Court for the Southern District of Texas ruled in the Scotia Pacific case that an ad hoc committee of bondholders was not subject to the disclosure requirements of Bankruptcy Rule 2019.

The International Securities Dealers Association, which submitted amicus briefs in both cases, has indicated its intention to continue to appear in cases where this issue is raised. In this period of uncertainty, hedge fund managers will need to decide whether the potential additional benefits from participating in ad hoc committees in a particular case are outweighed by the possible negatives associated with the public disclosure of their acquired positions and the dates and prices of such acquisitions.

Bankruptcy Court Imposes Liability on Prime Broker in Manhattan Fund Case

In another significant recent decision, the United States Bankruptcy Court for the Southern District of New York held Bear, Stearns Securities Corp. liable to return to the bankruptcy estate of Manhattan Investment Fund, a failed hedge fund for which Bear Stearns acted as prime broker, more than $125 million in margin payments that Bear Stearns had received from the fund before the fund ceased operations. The Bankruptcy Court also required Bear Stearns to pay an additional $34 million in pre-judgment interest, even though Bear Stearns had earned only $2.4 million in fees from the hedge fund.

The Bankruptcy Court concluded that all payments made in what was in effect a ponzi scheme are inherently fraudulent by nature, that the hedge fund had paid its margin debt to Bear Stearns with actual intent to hinder, delay or defraud its creditors, and that the payments were therefore fraudulent transfers. The Bankruptcy Court rejected the defense that Bear Stearns received the transfer for value and in good faith. The Bankruptcy Court held that, in this case, Bear Stearns had received notice on a number of occasions that the hedge fund might be engaged in suspect activity, if not outright fraud. As a result, the court determined that Bear Stearns had not acted with sufficient diligence in this case to be protected by the good faith defense.

Massachusetts Brings Action Against Phillip Goldstein

On January 31, 2007, the Secretary of the Commonwealth of Massachusetts, William Gavin, filed an administrative complaint against hedge fund manager Phillip Goldstein, the hedge fund

manager who prevailed over the SEC last year in the court ruling striking down the hedge fund registration rule. Galvin has alleged that Goldstein and his hedge fund, Bulldog Investors, violated Massachusetts' general solicitation rules applicable to private investment funds by failing to restrict access to Bulldog's website to qualified investors. Bulldog maintained an interactive web site through which the general public had unrestricted access to advertising and offering materials of the fund.

Similar to Regulation D of the Securities Act of 1933, the Massachusetts Uniform Securities Act generally prohibits an issuer of securities from making an unregistered, non-exempt public offering of securities in Massachusetts. According to Massachusetts' Administrative Complaint (available at: http://www.sec.state.ma.us/sct/sctbulldog/bulldogidx.htm), the definition of "offer" under the Massachusetts Act requires "issuers offering securities privately to maintain proper controls over the materials available through an Internet web site." The complaint specifically notes that the Bulldog website did not contain password protection to ensure that only prospective investors that Bulldog has determined are properly accredited or sophisticated can access the advertising and offering materials. Massachusetts seeks a cease and desist order to prevent further violations of the Massachusetts securities laws and an administrative fine.

Illinois Sudan Act Enjoined

A recent lawsuit brought by the National Foreign Trade Council against the State of Illinois was successful in permanently enjoining an Illinois law that became effective in 2006 and that prohibited Illinois state pension plans from investing in any private equity or hedge fund unless the fund was willing and able to provide an affidavit sworn under oath that none of its portfolio companies had any direct or indirect business ties to Sudan. The legislation, the Act to End Terrorism and Atrocities in Sudan, had caused significant concerns due to the fact that many private equity fund managers have indicated that they would be unwilling and/or unable to make the necessary certifications about their portfolio companies. The Illinois legislature is currently working with the private equity community on a revised bill to address investments in Sudan and the hope is that any new legislation will address such concerns.

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Private Investment Funds Practice Update

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