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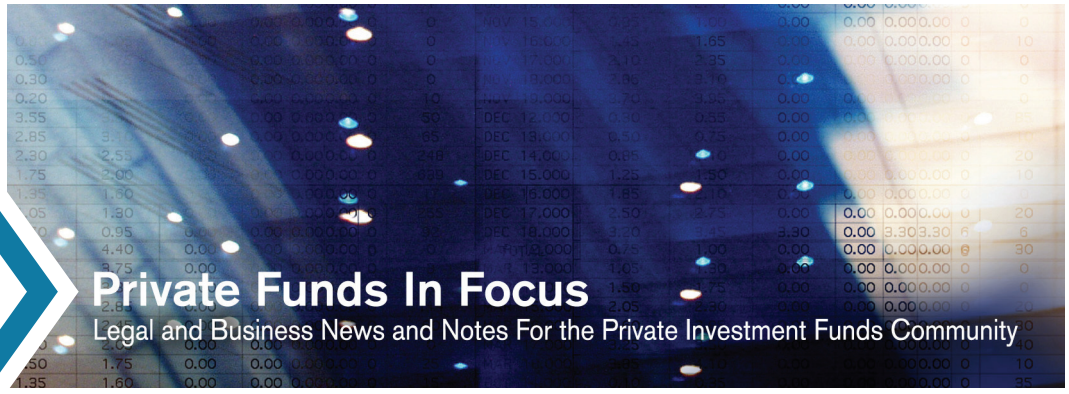

newsletter

Private Funds In Focus

Legal and Business News and Notes For the Private Investment Funds Community

FALL 2012

in this issue

I Want You to Want Me – Achieving a Successful First Closing

David W. Tegeler

A successful first closing can propel a private investment fund sponsor toward its fundraising target. Key factors that contribute to a successful first closing are planning, patience and, in a difficult fundraising market, creativity.

Strategy

Planning for a successful fundraising involves properly positioning a fund in the marketplace by obtaining feedback from prospective investors, choosing appropriate fund terms and building a strong team of investment professionals, managers, investor relations and back office personnel, accountants and lawyers.

By speaking with prospective investors before bringing a new fund to the market, a sponsor can obtain valuable information about which investors are most likely to participate in a first closing, the extent to which changes to the fund's terms, strategies or personnel, as compared to previous funds, would increase the sponsor's fundraising success and whether the sponsor's fundraising time line is aligned with investors' investment time lines. This data can be critical in setting the stage for a realistic time line and a fund structure that is acceptable to those involved.

Once a sponsor has this data, the next step is to set a target date for the first closing and establish a time and responsibility schedule. Getting all of the prospective first closing investors on the same time line and working towards the same date is often one of the

events

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most difficult things to do. Laying the groundwork ahead of time and being realistic and fair to those involved helps breed success.

PLANNING INVOLVES EVALUATING HOW THE TERMS OF THE SPONSOR'S EXISTING FUNDS FIT WITHIN THE CURRENT MARKET ENVIRONMENT.

Reality Check

Planning also involves evaluating how the terms of the sponsor's existing funds fit within the current market environment. Deal terms that were standard several years ago may now be viewed as off-market or inconsistent with current standards, including the private equity principles promoted by ILPA, which have garnered support among certain institutional limited partners. In recent years, changing deal terms have affected economic issues, such as waterfall structures, carried interest calculations, general partner clawbacks and management fee offsets, as well as more general matters such as the role of the advisory board, investment limitations and indemnity matters. Limited partners have been asking that distribution waterfalls delay the time when carried interest payments are made, that carried interest be calculated on a net instead of gross basis, that clawbacks work properly in practice and take into account tax considerations, and that management fees be offset by 100% of directors', transaction, monitoring and similar fees received by the sponsor and its affiliates.

The investor community is becoming increasingly more sophisticated, and a working knowledge of the fund's terms as compared to the ILPA principles is advisable. Fund sponsors may or may not need to update terms for a current offering, but a sponsor that is well-versed about the terms of its fund and reasons for why a term may be different from what is perceived to be "market" will be better positioned to successfully navigate negotiations with investors.

Get Your House in Order

Before bringing a new fund to market, a sponsor also should evaluate its personnel and make any changes necessary to ensure that its team has the skills, expertise and bench-strength to attract investors and support the operation of a new fund. A sponsor should make sure that it has the right people assigned to the appropriate tasks during fundraising. Having a leader for the process is critical to getting through diligence, investment committees and negotiations, and hitting target dates.

It is also crucial for the sponsor to assemble a strong team of outside advisors. First and foremost a sponsor must determine whether or not to hire a placement agent to support the fundraising. The choice of a placement agent is highly specific to the circumstances of each sponsor and fund, and a sponsor should interview a number of firms before making its final selection. In addition, experienced fund counsel and accountants, with in-depth of knowledge in the market, can ease the path to a successful close.

The Long and Winding Road

Sponsors follow a range of paths toward their first closing. Some are fortunate enough to be able to raise their first or next fund with minimal efforts in short periods of time. Most, however, follow a longer path toward their first closing. That path begins with sponsors focusing their marketing efforts on their best prospects which, for sponsors raising a successor fund, are their existing limited partners and, for sponsors of first-time funds, often are friends and family or, as described below, an anchor investor. Sponsors then

expand their marketing efforts to new groups of investors, such as investors that have similar characteristics to the sponsor's existing investors, investors with a particular interest in the sponsor's investment strategy and investors in other geographic regions.

FOR THE SPONSOR OF A FIRST-TIME FUND OR AN EMERGING MANAGER, FINDING AN ANCHOR INVESTOR CAN BE INVALUABLE.

Anchors Aweigh

For the sponsor of a first-time fund or an emerging manager, finding an anchor investor can be invaluable. An anchor investor can provide the sponsor with seed financing required to build its management team, fund the sponsor's early operations and provide capital for initial fundraising efforts. An anchor investor also can provide the sponsor with the marketplace credibility necessary to continue its fundraising, particularly where the anchor investor has name recognition in the industry or is otherwise expected to support the sponsor through its expertise, deal flow, industry contacts or operational infrastructure.

An anchor investor that takes a chance on a first-time fund or an emerging manager often will request beneficial terms that may include an ownership interest in the sponsor's management company, a right to receive a portion of the fund's carried interest, a discount on management fees or some combination of the foregoing.

Early Bird Special

An increasingly popular fundraising strategy, especially for more established firms, is to offer incentives to investors that participate in an upcoming fund's first or early closings. The most common of these so-called "early bird" incentives are management fee discounts, priority access to co-investment opportunities and, less frequently, carried interest discounts.

The dynamic of private equity fundraising, however, which can last 12 to 18 months or more, makes it difficult to limit early bird incentives to just early closers. We have seen many firms offer early bird incentives at the opening stages of a fundraising period only to end up granting those rights to all investors at the fundraising period's final stages.

Other Attractions

There are times when investors are motivated to participate in a fund's first closing even where a sponsor does not offer early closing incentives. An investor may be motivated to participate in a fund's first closing when it is investing large amounts of capital and wants to take a lead role in shaping the fund's terms or when it wants to secure a larger allocation to an oversubscribed fund.

A RECENTLY POPULAR EARLY CLOSING INCENTIVE HAS BEEN THE MANAGEMENT FEE DISCOUNT.

There are also times when investors are motivated to sit back and let other investors negotiate favorable terms and to evaluate the progress of the fund's early investments before committing to the fund. If properly implemented, sponsors can use early closing incentives to their advantage in an effort to offset the perceived benefit of participating in a fund's later closings.

Lighten My Load

A recently popular early closing incentive has been the management fee discount which can take many forms, with the most basic being a simple reduction to the management

fee charged over the life of a fund. Sponsors also sometimes offer management fee discounts on a portion of an investor's commitment amount or during specified time periods, such as during a fund's investment period or between the time of a fund's first and last closings.

While offering some form of management fee discount to early investors has become more common in recent years, the practice can yield undesirable results. Some managers that offer management fee discounts to early investors have found it difficult to hold the line with later investors demanding the same discount. Furthermore, a sponsor that offers lower management fees for some or all of the investors in its current fund may find it difficult to increase those fees for successor funds. Sponsors face the risk that a temporary and limited incentive becomes the new baseline for all of its investors.

THE RISK FOR SPONSORS IS THAT THEY GIVE UP SOME CONTROL OVER WHOM THEY PARTNER WITH ON CO-INVESTMENT OPPORTUNITIES, AND MANAGING MULTIPLE REQUESTS FOR CO-INVESTMENT RIGHTS AND PRIORITIES IS DIFFICULT.

While investors are very focused on the overall expenses associated with their investment, by and large they are also realistic about the amount of management fee income that is required for a sponsor to support a team adequate to operate a successful fund. "Alignment of interests" between sponsors and investors has been the drumbeat over the past few years and that is expected to continue.

A Piece of the Action

Another common early closing incentive requested by investors is a priority allocation on co-investment opportunities. Offering a priority on co-investments can be a seemingly easy concession for sponsors because it does not affect their management fees or carried interest directly. The risk for sponsors is that they give up some control over whom they partner with on co-investment opportunities, and managing multiple requests for co-investment rights and priorities is often difficult.

Last But Not Least

Other early closing incentives include offering early investors representation on a fund's advisory or investment committee, providing preferential rights to participate in future funds organized by the sponsor, permitting an investor's employees to participate in a sponsor-operated secondment program, providing carried interest discounts, providing the early investors with the opportunity to participate in specified co-investments that arise during the fundraising process and providing early investors with a priority allocation in one of the sponsor's other funds that is oversubscribed.

Achieving a first closing for a new fund can be a difficult process, but with planning, patience and creativity, a sponsor can put itself in the best position possible to successfully reach its fundraising targets in a manner that contributes to the long-term success of its organization.

SEC Proposes Rule Amendments To Permit General Solicitation in Private Offerings

On August 29, 2012, the Securities and Exchange Commission proposed amendments to Rule 506 of Regulation D and Rule 144A in order to implement Section 201(a) of the

Jumpstart Our Business Startups Act, known as the JOBS Act. The proposed amendments implement the JOBS Act mandate to permit general solicitation in offerings to accredited investors under Regulation D and to qualified institutional buyers (QIBs) under Rule 144A. These amendments will benefit both operating companies and private investment funds. The SEC's proposals would:

- Remove the prohibition against general solicitation and advertising for offerings to accredited investors under newly designated Rule 506(c) of Regulation D and to QIBs under Rule 144A;
- Impose new investor verification requirements;
- Preserve an issuer's ability to rely on pre-amendment Rule 506, which prohibits general solicitation, in order to avoid the new investor verification requirements (this approach will be characterized as a Rule 506(b) offering);
- Confirm that general solicitation continues to be prohibited in other private offerings under Section 4(a)(2) of the Securities Act;
- Confirm the ability of private investment funds to engage in general solicitation under new Rule 506(c) without undermining their claims to exemptions under Sections 3(c)(1) and 3(c)(7) of the Investment Company Act of 1940; and
- Confirm that the use of general solicitation in Rule 506 or Rule 144A offerings will not undermine the ability of issuers to undertake simultaneous Regulation S offerings outside the United States.

It is expected that the SEC will adopt the proposals without significant changes, and that the new rules will be effective before the end of 2012. In the interim, issuers should continue to follow the rules in their current forms, which prohibit general solicitation. For more information, please see our recent client alert SEC Proposes Rule Amendments To Permit General Solicitation in Private Offerings by Companies and Private Investment Funds.

STOCK Act Presents New Compliance Concerns for Advisers

On April 4, 2012, President Obama signed the Stop Trading on Congressional Knowledge Act (the STOCK Act), which imposes new fiduciary obligations on members of Congress, congressional staff and certain other federal government employees with respect to material, nonpublic information received by such persons through government channels.

Prior to the passage of the STOCK Act, the U.S. federal securities laws were unclear as to whether members of Congress, congressional employees and certain other government employees who receive material, nonpublic information through the official performance of their duties would be subject to insider trading laws. The STOCK Act clearly affirms that such government persons owe fiduciary obligations to the U.S. government and U.S. citizens with respect to material, nonpublic information derived from their governmental positions or gained from the performance of their official

responsibilities. As a result, such government persons cannot trade in securities of a company about which they are aware of material, nonpublic information obtained in their official capacities without violating federal securities law.

U.S. federal securities laws also impose potential liability on "tipees" who knowingly trade on material, nonpublic information that was provided in violation of a fiduciary duty. Accordingly, private fund advisers that directly or indirectly receive information from members of Congress, congressional staff or other government employees can be held liable if the adviser to the private fund knew or should have known that the information was disclosed by the government employee in breach of such duty.

ADVISERS SHOULD CONSIDER AMENDING THEIR COMPLIANCE POLICIES AS A RESULT OF THE STOCK ACT.

Advisers to hedge, private equity and other private funds should be wary of potential insider trading issues when receiving information from congressional members, congressional staff, government employees and other potential Washington insiders (such as lobbyists and consultants). Private fund advisers should also consider amending their compliance policies and procedures related to insider trading in order to remind employees of these obligations and to address how employees should interact with government insiders.

Many Funds-of-Funds Need To Take Urgent Action To Avoid CFTC Registration

As discussed in our prior client alerts CFTC and SEC Adopt Final Rules Defining Swaps; CFTC Repeals 4.13(a)(4) Exemption Used by Many Private Fund Managers, many fund-of-funds managers, including potentially managers of funds-of-funds investing primarily in private equity and venture capital funds, need to take urgent action in order to make sure that such funds-of-funds qualify for an exemption from registration with the Commodities Futures Trading Commission (CFTC).

ANY FUND-OF-FUNDS THAT INVESTS EVEN A MINIMAL AMOUNT IN A FUND THAT TRADES COMMODITY INTERESTS IS ITSELF A COMMODITY POOL.

Any fund-of-funds that invests even a minimal amount in a fund that trades commodity interests is itself a commodity pool. Historically, many fund-of-funds managers and sponsors were not affected by CFTC rules due to the exemption under Rule 4.13(a)(4), and the fact that CFTC rules generally only applied to futures. However, Rule 4.13(a)(4) has been repealed effective as of the end of 2012. The recent expansion of CFTC rules to cover many types of swaps and other over-the-counter instruments (such as interest rate swaps and certain foreign currency swaps and forwards) means that any fund-of-funds that invests in another fund that trades even a minimal amount of swaps or futures is potentially subject to CFTC registration, or at least the obligation to file for an exemption from registration under CFTC Rule 4.13(a)(3). This is the case even if the fund-of-funds only invests in one underlying fund that trades futures or swaps subject to CFTC regulation, and even if that underlying fund only trades a minimal amount of swaps or futures, or only for hedging purposes.

A fund-of-funds sponsor or manager will need to review, and if necessary reach out to, all of the underlying funds in which it invests in order to determine whether those underlying funds either do not trade instruments subject to CFTC regulation or will qualify for the limited trading exemption under Rule 4.13(a)(3). Currently, a fund-of-funds relying on

Rule 4.13(a)(3) must use one of the "look-through" approaches outlined in Appendix A previously adopted by the CFTC under Rule 4.13(a)(3), which illustrates the application of Rule 4.13(a)(3) in several hypothetical fund-of-funds situations. Appendix A is no longer available on the CFTC website, and will be replaced when new guidance is issued by the CFTC. However, the CFTC recently confirmed that fund managers can continue to rely on Appendix A until the CFTC has issued new guidance. A fund-of-funds that is relying on the exemption under Rule 4.13(a)(3) must file a simple claim for exemption with the CFTC.

CFTC Issues FAQ on CPO/CTA Compliance Obligations

On August 14, 2012, the Commodity Futures Trading Commission (CFTC) issued responses to a number of frequently asked questions prompted by recent amendments to CFTC rules (see our recent client alerts: CFTC Repeals 4.13(a)(4) Exemption Used by Many Private Fund Managers and CFTC and SEC Adopt Final Rules Defining Swaps). Among the guidance provided in the FAQ, the CFTC confirmed that:

- a general partner or managing member of a commodity pool can avoid registration as a commodity pool operator (CPO) if it properly delegates relevant obligations to a registered CPO;
- a fund planning to operate under the limited trading exemption under Rule 4.13(a)(3) may enter into swaps before making other investments, and will have a "reasonable time" to come into compliance with the trading limits under the Rule;
- the CFTC staff is working with the National Futures Association to permit managers to apply to register with the CFTC prior to the end of 2012, but have the effective date of the registration delayed until January 1, 2013;
- a fund operated under the Rule 4.13(a)(3) limited trading exemption need only ensure compliance with the trading limits each time a new position is established, and will not need to otherwise reconfigure its portfolio to fit within the limits; and
- a fund-of-funds may continue to rely on guidance in Appendix A under Rule 4.13(a)(3) (even though the Appendix is not currently available on the CFTC's web site) as to how to apply the Rule 4.13(a)(3) limits in a fund-of-funds context until the CFTC issues further guidance (see further discussion in *Many Funds-of-Funds Need To Take Urgent Action To Avoid CFTC Registration above*).

The CFTC staff also recently issued an interpretive letter permitting newly formed funds to rely on Rule 4.13(a)(4) until the end of 2012.

NFA Provides Exemption from Examination Requirements for Swap Firms

The National Futures Association (NFA) adopted amendments to its rules potentially simplifying the process for certain firms that trade swaps to register with the CFTC and become a member of the NFA. Among the key changes, which became effective on September 1, are:

- the creation of a new category of registration for "swap firms" that trade swaps in excess of the limits under CFTC Rule 4.13(a)(3) but do not trade futures in excess of the limits under Rule 4.13(a)(3); and
- the establishment of a procedure to waive the Series 3 examination requirement for associated persons of swap firms.

Securities Class Actions – A Developing Risk for Sponsors of Private Investment Funds

Timothy W. Mungovan and Amy Crafts

Virtually unheard of five years ago, securities class actions against private investment fund sponsors are now a growing risk. This development is the result of a combination of factors, including:

- a challenging economic and investment environment;
- disappointing returns at some funds;
- the Madoff fraud;
- the efforts of the plaintiffs' securities class action bar to cultivate relationships with certain institutional investors; and
- increased regulation of the private funds industry.

Despite these factors, the plaintiffs' securities class action bar still faces substantial challenges in pursuing private investment funds. The class action structure does not necessarily fit neatly within the private investment funds context, and the plaintiffs' bar will have to adapt. In addition, compared to the extensive body of case law involving securities class actions against publicly listed companies, there are few reported decisions involving securities class actions against private investment fund sponsors. Finally, conscientious private investment fund sponsors can take a few careful steps today to reduce their risk of defending a class action in the future.

A Brief History

Historically, the plaintiffs' bar has been extraordinarily successful – based purely on the number of suits filed and settlements achieved – in targeting various industries and challenging accepted practices within those industries. For example, over the last 30 years, the plaintiffs' bar has targeted, at various times, the information technology, biotech/pharma, medical device and financial services industries. Ten years ago, the plaintiffs' bar focused on large scandals at firms such as WorldCom and Tyco, as well as various financial market irregularities such as market timing at mutual funds and the IPO "laddering" and "spinning" cases. Following the financial crisis in 2008, the plaintiffs' bar focused on claims arising out of the securitization of subprime mortgages, the collapse of the auction rate securities market and various Ponzi schemes, including the Madoff fraud. Even more recently, the plaintiffs' bar has filed numerous claims in connection with M&A transactions, on the theory that the purchase price was inadequate, even in situations where the price was at a substantial premium to the pre-announcement closing price.

OVER THE LAST 30 YEARS, THE PLAINTIFFS' BAR HAS TARGETED, AT VARIOUS TIMES, THE INFORMATION TECHNOLOGY, BIOTECH/PHARMA, MEDICAL DEVICE AND FINANCIAL SERVICES INDUSTRIES.

Despite this success, the securities class action industry has undergone material changes over the last two decades. Perhaps the most important changes were implemented as part of the Private Securities Litigation Reform Act of 1995 (the Act) which made it more difficult, as a practical matter, to bring a securities class action.

Among the most radical of the reforms that the Act imposed were the so-called lead plaintiff provisions. The lead plaintiff provisions were intended, in part, to impose investor control over the litigation and eliminate the perceived abuse of lawyer-driven litigation by giving control to the investor or group of investors with the largest financial interest. These provisions create a rebuttable presumption that the person or group of persons with the largest financial stake in the relief sought constitutes the most adequate plaintiff. Under the Act, the court appoints the most adequate plaintiff as lead plaintiff and the lead plaintiff then selects counsel.

THE PLAINTIFFS' BAR WILL DRAW HEAVILY ON THEIR STRATEGIES AND THEORIES IN DEALING WITH PUBLICLY TRADED COMPANIES.

In response to the lead plaintiff provisions, the plaintiffs' bar developed strong relationships with a variety of institutional investors, including public pension plans. Over the last 17 years, a variety of these institutional investors have been appointed as a lead plaintiff in dozens of securities class actions. These institutional investors have become highly sophisticated in litigation and securities matters. Many of these same institutional investors hold investments in private investment funds.

Learning from History

If the cases that have been brought so far against private investment fund sponsors are any indication, the plaintiffs' bar will draw heavily on their strategies and theories in dealing with publicly traded companies. Therefore, fund sponsors have a good roadmap for the securities law-based claims that may lie ahead, including:

- Section 10(b) of the Securities Exchange Act of 1934 (the Exchange Act) and corresponding Rule 10b-5, which relate to fraud in connection with the purchase or sale of a security and require proof of causation, reliance and knowledge or intent;
- Section 12(a)(2) of the Securities Act of 1933 (the Securities Act), which creates liability for any person who offers or sells a security through a prospectus or an oral communication containing a material misstatement or omission; and
- Section 15 of the Securities Act, which creates liability for those persons who control an issuer for misinformation in a registration statement, prospectus or distribution of securities, and helps investors collect damages when the issuer does not have enough money to pay the investors.

The Class Action: Leverage for Lawyers

A fundamental purpose of the class action structure is to create economies of scale and promote fairness, for both plaintiffs and defendants. For the plaintiffs' bar, class actions are also the litigation equivalent of "leverage" in a transaction. A lawyer who represents one client can bring a class action on behalf of all persons who are similarly situated. In doing so, the lawyer has an opportunity for significantly greater fees based on a contingency fee agreement and obtains greater bargaining power with the defendants. The prospect of having to defend a class action is oftentimes sufficient to bring companies to the settlement table. As the U.S. Court of Appeals for the Fifth Circuit has observed, "class certification may be the backbreaking decision that places 'insurmountable pressure' on a defendant to settle, even where the defendant has a good chance of succeeding on the merits."

Certifying a Class: Easier Pled Than Done

Filing a putative securities class action lawsuit is one thing; establishing that a class should be certified is another matter entirely. To achieve class certification, plaintiffs must meet a variety of requirements. One of the key requirements, commonly referred to as the predominance requirement, places the burden on plaintiffs to show the court that questions of law or fact common to the members of the class predominate over any questions affecting only individual members of the class.

Demonstrating predominance can be particularly difficult in a securities fraud suit. To establish a claim of securities fraud under Section 10(b) of the Exchange Act, a plaintiff must prove six elements, including reliance on a material misstatement or omission of fact at the time of purchasing or selling a security. According to the U.S. Supreme Court, proving reliance provides the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury. For class certification, plaintiffs must demonstrate that each member of the entire class relied on the alleged misstatement or omission in making the investment decision.

In a securities fraud suit, plaintiffs regularly rely on the "fraud on the market" theory to establish reliance. The fraud on the market theory stands for the proposition that, in an efficient market, information that is available to the public is rapidly absorbed by the market and reflected in the price of a security, even though individual market participants

may be unaware of the information. The U.S. Supreme Court accepted the fraud on the market theory in 1988 in *Basic v. Levinson*.

ABSENT THE FRAUD ON THE MARKET PRESUMPTION, PLAINTIFFS FACE A SUBSTANTIAL CHALLENGE IN ACHIEVING CLASS CERTIFICATION.

In *Basic*, the Court held that when an investor purchases a security at a price that has been inflated by false or misleading information, and when the investor reasonably believes that the market price reflects all available information, a court can presume that the investor relied on the false or misleading information. As a result, in instances where the fraud on the market theory applies, plaintiffs do not have to prove individual reliance on the alleged misstatement or omission, as the court presumes such reliance. Absent the fraud on the market presumption, plaintiffs face a substantial challenge in achieving class certification because individual issues of reliance generally preclude a finding that common issues predominate.

In a putative class action alleging securities fraud against a private investment fund sponsor, it will be difficult – if not impossible – for a plaintiff to utilize the fraud on the market theory because investment interests in a private investment fund do not trade in an efficient market.[1] Indeed, the *Basic* Court focused heavily on the concept of an impersonal, well-developed market for securities in adopting the fraud on the market theory. The *Basic* Court distinguished between the modern securities markets, which involve literally millions of shares changing hands daily, and face-to-face transactions where the inquiry into an investor's reliance upon information relates to the subjective pricing of that information by that investor. In a private investment fund context, there is generally nothing remotely approaching an impersonal, well-developed market for interests in a private investment fund.

PRIVATE INVESTMENT FUND SPONSORS THAT ARE LAUNCHING NEW FUNDS CAN TAKE STEPS TODAY TO REDUCE THE RISK OF LITIGATION.

How to Reduce the Risk of a Securities Class Action

Private investment fund sponsors that are launching new funds can take steps today to reduce the risk of litigation in general, and class actions in particular, including the following:

[1] Courts typically consider five factors in determining whether a security trades in an efficient market. These include: (1) the security's average weekly trading volume expressed as a percentage of total outstanding shares; (2) the number of securities analysts reporting on the security; (3) the extent to which market makers and arbitrageurs trade in the security; (4) the issuer's eligibility to file SEC Form S-3 (a short form registration statement that is reserved for companies that have $75 million in common equity held by non-affiliates of the registrant and have filed reports with the SEC for 12 consecutive months); and (5) facts demonstrating a cause and effect relationship between unpredicted corporate events or releases of financial data and an immediate reaction in the security's price.

- Note in the private placement memorandum the nature and purpose of an investment in the private investment fund, the differences between an investment in a private investment fund and an investment in public equity, and the fact that the interests in the private fund are illiquid and not traded in any market;

  Consider whether a mandatory arbitration provision that precludes class actions in the arbitration context, as part of the standard form subscription agreement for the fund, is right for the particular sponsor's situation. The business case and the legal case for mandatory arbitration provisions is highly fact-specific, and the benefits of any such provision may be outweighed by the detriments. In addition, the enforceability of such provisions varies among the states and federal courts;
- Prohibit the transfer of interests in the fund without the prior written consent of the general partner or management company, as is typically the case;
- Carefully adhere to the rules and regulations concerning private offerings of securities, and consider thoroughly the ramifications of general advertising and solicitation under the recently enacted Jumpstart Our Business Startups Act (JOBS Act);
- Expressly avoid or limit duties of disclosure in the fund documents; and
- Make extensive disclosure of risks in order to take advantage of the "bespeaks caution" doctrine, which states that if soft information in a prospectus (including forecasts, opinions, estimates and projections about future performance) is accompanied by cautionary language that warns the investors about the actual results or events that may affect performance, then the soft information may not be substantially misleading to investors.

Conclusion

Securities class actions are a nascent risk for private investment fund sponsors. While the law in this area is still developing, sponsors can and should take steps to reduce their future risks.

Updates on Executive Compensation and Human Capital Issues

Michael J. Album

This update highlights developments in the area of compensation and "human capital" management that are relevant to the private investment funds community. In particular, this update focuses on: (1) case developments in New York, where older state wage laws are being relied upon to recover guaranteed compensation; (2) indemnification issues relating to internal firm disputes; and (3) ensuring that team members engaged in international travel are protected under workers' compensation

State Wage Laws and Guaranteed Compensation Claims

Senior personnel who run private investment firms are well-versed in hiring new team members and negotiating contracts that reflect relevant compensation terms, often including guaranteed compensation for one or two years for higher level hires. It is no

longer prudent, however, to assume that if matters deteriorate, and an executive is terminated, claims for guaranteed compensation will be limited just to amounts alleged to be due under the contract if the firm decides to fight payment. In recent years a number of cases brought by executives have raised claims for guaranteed bonuses and other guaranteed payments under state wage laws (state statutes originally passed to protect factory workers and laborers from wrongfully withheld earned wages). These socially progressive statutes also provide for remedies in excess of contract damages (e.g., the recovery of penalties and attorneys' fees).

WAGE LAWS PROVIDE FOR REMEDIES IN EXCESS OF CONTRACT DAMAGES (E.G., THE RECOVERY OF PENALTIES AND ATTORNEYS' FEES).

Developments in recent years, at least in New York, have moved the focus of these statutes outside the context of factory workers. One recent case (2011) involved a managing director/general counsel of a failed hedge fund who was permitted to assert a claim under New York labor law for $2 million in "guaranteed compensation" (he was guaranteed that amount for two years, after applying his draw and share of incentive and management fees). According to the court in that case, because the applicable term sheet provided that these payments were mandatory and "sums certain," they constituted unpaid wages. *Wachter v. Kim*, 82 A.D.3d 658, 663 (1st Dep't 2011). In another recent case (2012), the highest state court in New York held that a senior trader who was induced to join a firm with a guaranteed bonus could assert a claim under New York labor law to "earned wages" when he was terminated and the bonus was not paid. *Ryan v. Kellogg Partners Institutional Servs.*, 19 N.Y.3d 1, 16 (2012). Given developments in this area–and many other states, in addition to New York, have these type of labor laws–it is recommended that any language providing for guaranteed compensation or bonuses be reviewed with counsel in advance so that steps can be taken, to the maximum extent possible, to limit disputed amounts to contract damages only, and not penalties or attorneys' fees.

Internal Disputes and Indemnification Obligations

Litigation between a firm and its former team members may arise from time to time. Perhaps a team member has left and violated post-termination covenants or a team member has been involuntarily terminated and is asserting claims against the firm related to that termination. In these situations it is important to understand the scope of the firm's indemnification provisions, and whether they would apply to these types of internal disputes between the general partner entity or management company and the former team member. If they do apply, the firm may face a "boomerang" indemnity claim, and be liable for expenses incurred by (or even the advancement of fees and expenses incurred by) a former team member who is either the target of that type of firm litigation or has initiated litigation against the firm.

In addition, if a firm disputes indemnification claims and loses, in some situations the prevailing party may recover the legal fees incurred to establish the right to indemnification in the first place (so–called "fees on fees"). This has been the long-standing rule in Delaware. This past summer, however, a New York court held that New York's limited liability company statute does not expressly provide for an award of fees on fees, and the limited liability company agreement in question did not do so either. *546-552 West 146th Street LLC v. Arfa*, No. 6169NA, 2012 N.Y. App. Div. LEXIS 5819, at *6 (1st Dep't Aug. 7, 2012).

It makes sense to regularly review the firm's indemnification provisions for these issues, and to review the indemnification provisions in other operative documents to which team members are parties so that there is an understanding among the constituents as to the rights and obligations under any indemnity provisions.

Extending Workers' Compensation Protection to Foreign Travel

As international business expands, and firms send their team members around the world to pursue opportunities, steps should be taken to review workers' compensation coverage. This is important for two reasons. First, the world now seems like a more dangerous place, with threats ranging from terrorism to pandemic events. Second, workers' compensation provides employees with the exclusive remedy for work-related injuries, and bars employees from suing the firm and its principals.

THERE MAY BE TECHNICAL COVERAGE ISSUES THAT ARISE WHEN FIRM EMPLOYEES ARE PUT ON EXTENDED OR PERMANENT ASSIGNMENT TO FOREIGN JURISDICTIONS.

Generally, while workers' compensation coverage will extend to firm employees based in the U.S. and who engage in foreign travel, there may be technical coverage issues that arise when firm employees are put on extended or permanent assignment to foreign jurisdictions. In these cases, there may be supplemental workers' compensation insurance that can be purchased to protect the firm. The best step to take to protect the firm is to review these issues carefully with the firm's outside insurance broker, insurer and counsel.

Tax Update – FATCA

Background

Enacted in 2010, the purpose of the Foreign Account Tax Compliance Act (FATCA) is to prevent tax evasion by U.S. taxpayers using non-U.S. accounts. To accomplish this, FATCA imposes a withholding tax on non-U.S. entities unless U.S. account holders are disclosed. To avoid this withholding tax, FATCA generally requires every foreign financial institution (FFI)–which includes non-U.S. investment funds and alternative investment vehicles, as well as non-U.S. conventional financial institutions such as banks–to enter into an FFI Agreement with the Internal Revenue Service (IRS) and to comply with specific documentation and information reporting requirements with respect to its U.S. account holders. If an FFI is not in compliance with FATCA, that FFI generally will be subject to a 30% withholding tax on any withholdable payments. Non-U.S. entities that are not FFIs (non-financial foreign entities, or NFFEs) also may be subject to withholding, unless such NFFE either certifies that it has no substantial U.S. owners or discloses such U.S. ownership.

A withholdable payment is broadly defined to include any payment of income from sources within the U.S. (other than income effectively connected with a U.S. trade or business) received after December 31, 2013 or gross proceeds from the sale of property that can produce either interest or dividends from U.S. sources realized after December 31, 2014.

Proposed Regulations

On February 8, 2012, the U.S. Treasury Department and the IRS released widely anticipated proposed regulations (the Proposed Regulations) implementing FATCA. The Proposed Regulations represent comprehensive guidance on the step-by-step process for complying with FATCA in order to be exempt from withholding. The Proposed Regulations describe the mechanics of U.S. account identification, information reporting and withholding for FFIs, as well as for NFFEs and U.S. withholding agents. In addition, the Proposed Regulations describe entities that are exempt from FATCA, including certain qualified collective investment vehicles, retirement funds and charitable organizations.

THE PROPOSED REGULATIONS REPRESENT COMPREHENSIVE GUIDANCE ON THE STEP-BY-STEP PROCESS FOR COMPLYING WITH FATCA IN ORDER TO BE EXEMPT FROM WITHHOLDING.

Intergovernmental Agreements

Simultaneously with the issuance of the Proposed Regulations, the Treasury Department jointly issued a statement with the governments of France, Germany, Italy, Spain and the United Kingdom about pursuing a government-to-government framework (referred to as Intergovernmental Model I) for implementing FATCA. Under this framework, an FFI in France, for example, would avoid FATCA withholding on payments made to it by reporting U.S. account holder information to French tax authorities. On June 21, 2012, joint statements between the U.S. and Switzerland and the U.S. and Japan introduced a different government-to-government framework (referred to as Intergovernmental Model II). This framework is intended to provide a way for financial institutions in these countries to comply with FATCA without violating their domestic laws, but still contemplates that FFIs in these countries will have to enter into FFI Agreements. Model agreements under Intergovernmental Model I were released on July 26, 2012, while a model under Intergovernmental Model II has yet to be released.

New W-8 Forms

Implementation of FATCA also requires revisions to certain IRS tax forms. On May 31, 2012, the IRS released a revised draft Form W-8BEN and a draft of a new Form W-8BEN-E for entities (as opposed to individuals). On August 13, 2012, the IRS released a revised draft Form W-8IMY. These are all in draft form at this stage, and the IRS has not yet released instructions to the revised forms. The Form W-8BEN-E and Form W-8IMY include a line for an entity to indicate its “FATCA status,” providing more than 20 choices.

Current Time Line

- Under the Proposed Regulations, the IRS is supposed to begin accepting FFI applications on January 1, 2013.
- To be considered a participating FFI (one that has complied with FATCA to avoid withholding tax) as of January 1, 2014, an FFI must enter into an FFI Agreement by June 30, 2013.
- On January 1, 2014, FATCA withholding will start to apply to U.S.-source income (such as interest, dividends and royalties).
- On January 1, 2015, FATCA withholding will start to apply to gross proceeds from the sale of property that can produce U.S.-source income (such as U.S. corporate stock or debt).
- Under prior IRS guidance, in certain circumstances, participating FFIs would have to withhold on non-U.S. income payable to recalcitrant account holders (so-called foreign passthru payments). This controversial type of withholding has been deferred until January 1, 2017 to give the IRS and the Treasury Department more time to study whether and how implementation will work.

The Proposed Regulations are not effective until finalized, the timing of which is still uncertain.

New York City Suspends Audit Position That Could Have Resulted in Increased Unincorporated Business Tax

New York City has suspended a controversial audit position which, if implemented, could have resulted in increased New York City unincorporated business tax (UBT) liabilities for investment advisers of private investment funds operating in New York City. In the February 2012 issue of our Private Investment Funds Update, available here, it was reported that the New York City Department of Finance was considering a new audit position regarding the application of the UBT to carried interest income received by investment advisers. The new position would have shifted expenses incurred in the management of the fund away from the management company entity (which is generally subject to UBT), to the carried interest entity (which is generally not subject to UBT, and thus has no use for the deductions), resulting in increased taxable income for, and UBT payable by, the management company entity. The Department of Finance reportedly began a few of these audits but did not issue any known assessments under the new position prior to the position's suspension. No formal announcement has been made, but the suspension of the audit position has been acknowledged by a spokesman for the Department.

Accessing European Capital – AIFMD

As widely reported, the European Directive on Alternative Investment Fund Managers (AIFMD) became law on July 21, 2011 and will radically change the regulatory and supervisory framework for the management and administration of alternative investment funds across Europe. The member states of the European Union must have legislation implementing the AIFMD by July 22, 2013. The AIFMD raises many questions for fund managers but specific and detailed advice must wait for the implementing measures, technical standards and guidelines. Recently, the EU regulator has pushed back its timetable for publishing draft implementing measures to September 2012.

Not Quite Blue Sky Thinking

While the details may not yet be available, fund managers can usefully consider some practical implications on fundraising and ongoing operations.

- Uncertainty as to the regulatory environment understandably has caused managers to consider the structures most suitable for ensuring a smooth fundraising and the efficient operation of the fund throughout its life. The AIFMD will certainly increase the costs of operating a fund, and even non-EU managers should consider who will ultimately bear those costs.
- Timing of launch and fundraising also has been impacted by the uncertainty, although the effects may have been masked by the current fundraising environment. A manager considering launching a fund should think about how the fundraising timeline fits with the known AIFMD deadlines (set out below).
- To access European professional investors from 2013 on, non-EU managers will at a minimum need to comply with the AIFMD's transparency and portfolio company requirements, even if they continue to operate under the national private placement regimes. These requirements relate to reporting (both to investors and to the relevant EU regulator) and to prohibitions on "asset stripping" in respect of portfolio companies (the rules restrict distributions, capital reductions, share buybacks and redemptions, save broadly out of "distributable profits" where the company's net assets would at a minimum remain equal to its subscribed capital plus undistributable reserves). Managers can start to prepare their operations to meet these requirements.
- Even when the implementing details are available, it will take time to establish how the AIFMD will impact day-to-day operations. What is evident is the current trend in Europe towards greater transparency in relation both to portfolio company operations and the operational structure, management and remuneration within fund managers. Non-EU managers should be aware of the changing environment and begin to prepare their operations to meet the challenges and opportunities ahead.

AIFMD Marketing Time Line

- Up to mid-2013 – Non-EU managers should market to EU professional investors in accordance with the relevant national private placement regime in the relevant member state.
- 2013 to 2015 – During this period, member states may allow a non-EU manager to market in their territory in accordance with national private placement regimes. A non-EU manager must comply with the transparency and portfolio company requirements of the AIFMD. A member state can choose whether to allow marketing on this basis and can impose stricter rules.
- 2015 to 2018 – In this period, a non-EU manager may continue to market to EU professional investors using national private placement regimes. Alternatively, a non-EU manager may be able to become authorized under the AIFMD and be subject to full compliance with the AIFMD.
- After 2018 – The AIFMD sets out a procedure under which national private placement regimes may be terminated, but this cannot happen before 2018 and will only take place on the recommendation of the EU regulator. If the regimes are abolished, a non-EU manager wishing to market to EU professional investors would be required to comply in full with the AIFMD.

UK FSA Consults on Changes to the Fund Marketing Regime

On August 22, 2012, the UK Financial Services Authority (FSA) published a consultation paper that proposes to further increase the existing strict restrictions on the ability of firms to market funds, among other products, to individual investors in the UK. The consultation results from the FSA's growing concern that retail investors have been inappropriately sold investments in unregulated collective investment schemes, such as private equity or hedge funds structured as Cayman Islands funds, Delaware limited partnerships and even English limited partnerships, and other non-mainstream pooled investments, largely on the part of retail distributors. However, the rule changes proposed by the FSA would reach beyond just retail distributors, and instead apply to all FSA-authorized firms seeking to market such investments to retail clients.

THE FSA'S PROPOSALS SEEK TO CIRCUMSCRIBE EXEMPTIONS THAT FIRMS RELY ON WHEN MARKETING TO INDIVIDUAL INVESTORS IN THE UK.

Narrower Exemptions

The FSA's proposals seek to circumscribe, or in some circumstances eliminate entirely, particular exemptions that firms rely on when marketing to individual investors in the UK. Several exemptions contained within the FSA's rules are intended to be modified or removed, such as the exemption for FSA-authorized firms marketing to current participants in a collective investment scheme. The FSA also has proposed guidance that, if finalized, would tighten the use of statutory marketing exemptions for sophisticated and high net worth investors. Among the conditions attached to each of these exemptions is the requirement that the marketing firm have a "reasonable belief" that the investor in question meets the criteria of the relevant exemption. The FSA's proposed guidance clarifies this requirement by providing that a firm should take "reasonable steps" to ascertain and satisfy itself that the investor meets the criteria of the relevant exemption.

Most importantly, the proposed FSA guidance seeks to clarify that firms should not promote products, even where an exemption is technically available, if it would not be appropriate or in the investor's best interests. For example, for high net worth investors, the FSA guidance suggests that an individual who would otherwise meet the financial criteria may be unable to properly understand and evaluate the risks of the investment in question if such investor does not also meet the criteria applicable to the sophisticated investor exemption.

New Compliance Requirements

The FSA's proposals also create new compliance requirements on FSA-authorized firms marketing collective investment schemes, including personal responsibilities on the part of a firm's compliance officer when marketing funds to individual investors. Proposed new record keeping rules, if made final, will impose significant new procedural and documenting requirements, requiring FSA-authorized firms to ensure that they retain both documentary and justificatory records when marketing funds to individuals.

UNAUTHORIZED FIRMS MARKETING FUNDS IN THE UK WOULD BE WISE TO CONSIDER THE FSA'S RULE CHANGES AND NEW GUIDANCE.

Considerations for Unauthorized Firms

While the proposed rules impose new requirements on FSA-authorized firms seeking to rely on exemptions for marketing to individual investors, it is clear that unauthorized firms marketing funds in the UK, including many non-UK firms, would be wise to consider the FSA's rule changes and new guidance as indicative of the general approach that the FSA is now taking toward the marketing of funds to individual investors in the UK. It is evident from the proposed rules that the FSA is concerned that individual investors are being inappropriately sold funds and other related products, and given that a contravention of the UK's financial promotions regime by an unauthorized firm is a criminal offense, unauthorized firms would be wise to revisit their marketing procedures in light of the FSA's proposals. Because unauthorized firms must rely on statutory exemptions when marketing to individual investors, they should consider the FSA's guidance regarding those exemptions when determining whether or not the conditions within those exemptions are satisfied, and pay particular attention to whether the marketing materials themselves contain any required warnings or indications. Unauthorized firms also should strongly consider whether they might wish to retain records in much the same manner as required of FSA-authorized firms by the proposed rules, particularly as a safeguard against any future regulatory problems that may arise.

The FSA's consultation closes on November 14, 2012. Finalized rules and guidance are expected to be published during the first quarter of 2013.

FINRA Adopts Rule To Require Filings for Certain Private Placements

The Financial Industry Regulatory Authority (FINRA) has adopted, and the Securities and Exchange Commission has approved, FINRA Rule 5123, which requires FINRA members that sell certain private placements to file a copy of any private placement memorandum, term sheet or other offering document used in connection with that private placement with FINRA within 15 days after the first sale, or to indicate to FINRA that no

such offering documents were used. FINRA members also must file any materially amended versions of documents originally filed with FINRA. The new Rule potentially impacts private investment fund sponsors that sell interests in funds through third party marketers or placement agents, nearly all of which are required to be registered as broker-dealers and are therefore subject to the Rule.

However, Rule 5123 exempts several types of private placements, including offerings sold only to "qualified purchasers," as defined in the Investment Company Act of 1940, and "knowledgeable employees," as defined in Rule 3c-5 under the Investment Company Act. As a result, offerings of interests in private investment funds that rely on the exemption under Section 3(c)(7) of the Investment Company Act are exempt from the requirements of Rule 5123. Rule 5123 also exempts offerings sold to certain categories of "accredited investors" within the meaning of the Securities Act of 1933. Natural person accredited investors who are not employees or affiliates of the issuer and certain entities that are considered to be accredited investors because all of their owners are accredited investors are not exempted by Rule 5123. As a result, private placements of interests in private investment funds that rely on the exemption under Section 3(c)(1) of the Investment Company Act and that include such natural persons or entities (or that include non-accredited investors) may be subject to the requirements of Rule 5123.

Rule 5123(c) provides confidential treatment to all documents and information filed with FINRA pursuant to the Rule and provides that such documents and information may be used by FINRA solely for the purpose of determining compliance with FINRA rules or other applicable regulatory purposes as "deemed appropriate" by FINRA. Documents must be filed with FINRA electronically.

The Rule becomes effective on December 3, 2012 and applies prospectively to private placements for which selling efforts begin on or after that date.

Appeals Court Makes It Harder To Protect Company Secrets under Federal Anti-Hacking Law

Jeffrey D. Neuburger

The Computer Fraud and Abuse Act is the federal anti-hacking law that criminalizes access to a computer or a computer network that is "without authorization," or in excess of authorized access. Companies have used the civil provisions of the Act against former employees who downloaded confidential company documents for the benefit of a competing company, on the theory that the employees' access was unauthorized under those circumstances. But this spring, in *United States v. Nosal*, the U.S. Court of Appeals for the Ninth Circuit ruled that the Act does not apply where an employee misappropriates company documents if the employee had permission to access the documents at the time they were misappropriated. The court ruled that under those circumstances, the employee's access was not "without authorization" or in excess of authorization within the meaning of the Act. In July, in *WEC Carolina Energy Solutions LLC v. Miller*, the U.S. Court of Appeals for the Fourth Circuit came to the same conclusion.

What this means is that when companies are marshaling their remedies against former employees who use misappropriated company data to compete, they may find it harder to get into federal court, both in the Ninth Circuit (which covers California, Alaska and other far western states), the Fourth Circuit (which covers the Carolinas, Virginia, West Virginia, Maryland and Delaware), and various other federal districts where the courts have similarly ruled. Employers typically have an array of potential claims against employees who misappropriate computer data, but they are primarily state law claims that ordinarily are brought only in state courts. Being able to bootstrap those state law claims into a federal court by including a federal Computer Fraud and Abuse Act claim is highly desirable from a strategic point of view.

How have other federal appeals courts ruled on this issue? The federal courts are split. The Seventh Circuit, for example, ruled that an employee's act of copying company documents in order to compete with his employer was a disloyal act that by itself rendered the employee's access to the employer's computer network unauthorized within the meaning of the Act.

It was thought that the U.S. Department of Justice might seek to bring the *Nosal* case to the U.S. Supreme Court, which could resolve the disagreement. But in August, the Department of Justice said that it would not take a further appeal in the case, and thus the Ninth Circuit ruling will stand.

Congress has the power to amend the statute to clarify this issue, and there is legislation currently pending that would make it clear that the Act encompasses employee misappropriation of employer data. But gridlock in Washington makes a clarification of the Computer Fraud and Abuse Act unlikely in the near future.

To read more about this issue, read this post on the Proskauer New Media and Technology Law blog, Ninth Circuit Ruling Trimming CFAA Claims for Misappropriation Reminds Employers that Technical Network Security is the First Defense.

Use It or Lose It – Increased Gift and GST Exemption Amounts Expire on 12/31/12

Ivan Taback

The 2010 Tax Act made the following significant modifications to the estate, gift and generation-skipping transfer (GST) taxes:

- Reduced the estate, gift and GST tax rates to 35%;
- Increased the estate tax exemption from $3.5 million to $5 million;
- Increased the GST tax exemption to $5 million; and
- Reunified the estate and gift tax exemptions so that an individual can gift up to $5 million during life.

Unfortunately, these favorable provisions may remain in effect only through December 31, 2012. Unless the law changes, in 2013 estate, gift and GST taxation reverts to the 2001 law. The top gift and estate tax rate will be 55%, and the estate and gift tax exemptions will be $1 million. In addition, the GST tax rate will revert to 55%, and the GST tax exemption will be $1 million (indexed for inflation). Moreover, certain favorable provisions in the GST tax laws that were enacted in 2001 would no longer apply. Thus, fund managers and other high net worth individuals should consider one or more of the following planning techniques before the current law expires.

MAKING A GIFT DURING LIFE NOT ONLY REDUCES YOUR ESTATE BY THE AMOUNT GIFTED, BUT ALSO BY ALL THE APPRECIATION ON THAT GIFT OVER TIME.

Use Your Gift Tax Exemption to Make Non-Taxable Gifts

With the increase in the gift tax exemption from $1,000,000 to $5,120,000 per person ($5,000,000 adjusted for inflation), you now have the ability to reduce your taxable estate by making direct gifts to anyone you wish to benefit (or to trusts for their benefit). In fact, a married couple can gift up to $10,240,000 without paying gift tax. Even if you used your entire gift tax exemption in prior years when it was limited to $1,000,000, the additional $4,120,000 increase in the gift tax exemption is available ($8,240,000 for a married couple, assuming each spouse gifted $1,000,000).

Additionally, if you made loans to your children or grandchildren, you may wish to use your gift tax exemption to forgive those notes.

Making a gift during life not only reduces your estate by the amount gifted, but also by all the appreciation on that gift over time. For example, if you make a $5 million gift this year and die 25 years from now, the value of that gift, including appreciation, will be over $21 million, assuming 6% growth.

Assets with high growth potential, such as carried interests in private investment funds, are often ideal assets to transfer by gift because all appreciation can be transferred gift and estate tax-free. Under the current tax laws, an opportunity like never before now exists to transfer assets without paying gift taxes.

THERE ARE MANY ADVANTAGES TO USING THE CURRENT EXEMPTION AMOUNTS TO MAKE GIFTS OF PROPERTY IN TRUST.

Gifts in Trust

Although it is simple to make a direct gift, there are many advantages to using the current exemption amounts to make gifts of property (such as interests in private investment funds) in trust. Gifts to trusts allow you to allocate your GST tax exemption to that trust and enable the gift, plus all future growth, to pass to your descendants without estate or GST tax at each beneficiary's death.

Gifts in trust also provide an additional opportunity for the trust's income to be taxed to you instead of to the trust or the trust beneficiaries. This lets you make additional tax-free gifts to the trust equal to the amount of tax the trust otherwise would pay.

Furthermore, gifts in trust are protected from claims by the beneficiary's creditors, including spouses, and ensure that the assets do not pass outside the family bloodline. These benefits apply at every generation for the longest period allowed under law.

Leveraging Your Gifts

Leveraging your gift tax exemption provides you the opportunity to get more bang for your buck. For instance, an alternative to making a gift of cash would be to gift interests in a private investment fund. Discounts may be available because the gift is a minority interest in a non-publicly traded entity. These discounts can be very significant and add further to the benefits of gifting today.

Tax Rates for Taxable Gifts (those above the $5 million exemption amount)

In 2012, the gift tax rate is 35%. In 2013, that rate is scheduled to revert to 2001 rates (ranging from 41% to 55% for gifts over $3 million). Thus, to the extent that you wish to make taxable gifts (those in excess of $5,120,000, the current individual lifetime gift exemption), you may wish to consider making such gifts this year. In addition to paying tax at a lower rate, the gift tax paid is removed from your estate (assuming you live for three years or more from the date the gift is made) and all appreciation is removed from your estate (and this is in addition to the gifted asset being removed from your estate).

The Devil is in the Details

A FUND MANAGER ALSO MUST FOCUS ON THE "THREE V'S" – VERTICAL SLICE, VESTING AND VALUATION.

In addition to general gift tax principles, a fund manager also must focus on the "Three V's" – vertical slice, vesting and valuation. When transferring a carried interest, a fund manager: (1) may be subject to a special gift tax valuation rule (the so-called "vertical slice" rule), (2) may be subject to a vesting schedule; and (3) should value the transferred interests for gift tax purposes and file a gift tax return. These items must be addressed with estate planning legal counsel to insure the gift is properly structured and reported for gift tax purposes.

A Potential Pitfall: The Clawback

Some practitioners have raised the concern that if a donor uses the increased exemption of $5,120,000 during 2012, and in 2013 that exemption is reduced back to $1 million, then there could be a potential clawback of the gifts made in excess of that reduced exemption when determining the estate tax owed by the donor's estate. There is, however, nothing in the current law to suggest that the government would take this approach.

In summary, individuals should take full advantage of the current exemption amounts and rates while the opportunity exists. Gifts always have the advantage of transferring future growth in addition to removing the transferred assets from the donor's estate.

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Our Private Investment Funds Group is comprised of more than 100 lawyers and advises clients worldwide on all of the legal and business issues important to private equity, venture capital and hedge fund sponsors, including structuring investment vehicles of all types and portfolio company investments, as well as institutional investor representation and secondary purchases and sales.

This newsletter is for clients and friends of our Private Investment Funds Group and discusses business and legal issues and developments affecting the private investment funds community.

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