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Regulation of OTC Derivatives Today and Tomorrow

The SEC's first insider trading enforcement action involving credit default swaps is leading the way

MANUEL S. FREY AND ADAM D.J. BALFOUR

In the aftermath of the bankruptcy filings by Lehman Brothers Holdings Inc. and certain of its subsidiaries and the ensuing market turmoil, credit default swaps ("CDS") have been cited as one of the main culprits for causing the current crisis. On September 23, 2008, former Chairman of the U.S. Securities and Exchange Commission (the "SEC") Christopher Cox testified before the Committee on Banking, Housing and Urban Affairs that the CDS market is "completely unregulated" and that "neither the SEC nor any regulator has authority over the CDS market."¹ On June 17, 2009, President Obama announced that the government is "proposing a sweeping overhaul of the financial regulatory system,"² including the "comprehensive regulation of credit default swaps and other derivatives that have threatened the entire financial system" (see inset on next page). On a parallel track, the SEC has intensified its focus on prosecuting fraud in connection with over the counter ("OTC") derivatives under its existing authority, and brought the first-ever enforcement action relating to insider trading in connection with CDS.³ This civil action comes at a pivotal time, as discussions continue on the proposed comprehensive regulatory framework for OTC derivatives and the roles that the Commodity Futures Trading Commission (the "CFTC") and the SEC will occupy in this framework. As such, this case offers an insight into the SEC's possible role and jurisdiction in the oversight of OTC derivatives.

Background on CDS

A CDS is an agreement between two parties, pursuant to which the protection buyer pays a one-time or periodic premium to the protection seller in exchange for a contingent payment of a specified amount if the entity referenced by the CDS experiences a "credit event" (usually a bankruptcy or a failure to pay its obligations). The trading prices of CDS fluctuate according to the perceived likelihood that the referenced entity will default on its obligations.

SEC v. Rorech and Negrin

The SEC brought this action based on an alleged violation of the antifraud provisions in the U.S. Securities Exchange Act of 1934, as amended (the "Exchange Act") and the *(continued on page 2)*

¹ Christopher Cox (former SEC Chairman). "Testimony Concerning Turmoil in U.S. Credit Markets: Recent Actions Regarding Government Sponsored Entities, Investment Banks and Other Financial Institutions before the Committee on Banking, Housing, and Urban Affairs." (Date: 9/23/08). Available at <http://www.sec.gov/news/testimony/2008/ts092308cc.htm>

² Remarks by the President on 21st Century Financial Regulatory Reform. (Date: 6/17/09). Available at http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform/

³ Securities and Exchange Commission v. Jon-Paul Rorech, et. al., Civil Action No. 09 CV 4329 (SDNY) ("SEC v. Rorech"). Available at <http://www.sec.gov/litigation/complaints/2009/comp21023.pdf>

Regulation of OTC Derivatives

(continued from page 1)

regulations promulgated thereunder. In its complaint, the SEC alleges that in July 2006, Jon-Paul Rorech, a bond and CDS salesman at Deutsche Bank Securities Inc., became privy to confidential information regarding the restructuring of an upcoming bond issuance by VNU N.V. ("VNU"), a Dutch media conglomerate. VNU was taken private by a consortium of private equity companies in May 2006, and in July 2006 announced a financing structure to fund the transaction mainly through debt issuances by VNU subsidiaries. Prior to the announcement of the final structure, the financing was restructured to include the issuance of a tranche of bonds by VNU. The new financing structure resulted in new debt of VNU, which in turn resulted in increased market value for CDS covering the default on such bonds.

The complaint alleges that Rorech provided Renato Negrin, then a portfolio manager at Millennium Partners, L.P. ("Millennium"), with confidential information regarding the proposed restructuring of VNU's financing. Negrin allegedly acted on this confidential information and purchased CDS that referenced VNU prior to the announcement of the new financing structure, resulting in a profit of \$1.2 million for Millennium when the bonds deal was announced and Negrin sold the VNU CDS. The complaint alleges that Rorech and Negrin violated Section 10(b)⁴ of the Exchange Act and Rule 10b-5 promulgated thereunder.⁵ In answers to the complaint submitted by Rorech and Negrin on June 19, 2009, both denied the SEC's allegations of insider trading and challenged the SEC's authority to bring the case arguing that the SEC does not have jurisdiction over a foreign company's securities or the CDS referencing such securities.

The SEC's Jurisdiction Over CDS

Despite the exponential growth of the CDS market over the last decade, the SEC's prior actions relating to insider trading so far have focused on equity and debt securities. This is the

President Obama's Plans for the Comprehensive Regulation of OTC Derivatives

On June 17, 2009, the U.S. Department of the Treasury released President Obama's plan to overhaul the U.S. financial regulatory system entitled "Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation." President Obama's plans for the comprehensive regulation of OTC derivatives include:

- (i) preventing activities in the OTC derivatives markets from posing risk to the financial system by requiring that all standardized OTC derivatives be cleared through regulated central counterparties;
- (ii) promoting both efficiency and transparency in these markets by amending the CEA and relevant securities laws to require that all OTC derivatives be subject to recordkeeping and reporting requirements, including an audit trail;
- (iii) preventing market manipulation, fraud and other market abuses by granting the CFTC and the SEC "unimpeded authority" to police fraud, market manipulation and other market abuses in connection with OTC derivatives; and
- (iv) ensuring that OTC derivatives are not marketed inappropriately to unsophisticated parties by evaluating the current eligibility criteria for investing in OTC derivatives and the imposition of additional disclosure requirements or standards of care when marketing derivatives to less sophisticated counterparties such as municipalities.

On August 11, 2009, the Treasury Department followed up on its white paper for regulation of OTC derivatives by releasing the "Over-the-Counter Derivatives Markets Act of 2009". The Over-the-Counter Derivatives Markets Act of 2009 contains proposed legislation that would implement the tenets of the previously published plan. The House Financial Services Committee and the Senate Banking Committee are expected to consider the proposed legislation and the extent to which it will be incorporated in their respective legislative proposals in the fall. ■

first time the SEC has pursued an action for insider trading relating to OTC derivatives. The SEC generally is prohibited from directly regulating swap agreements, including CDS and securities-based swap agreements, since they do not fall within the definition of a "security" under the Exchange Act or the U.S. Securities Act of 1933, as amended (the "Securities Act"). In 2000, both Acts were amended by the Commodity Futures Modernization Act of 2000 ("CFMA") to expressly prevent the SEC from requiring any registration of security-based swap agreements and to prohibit the SEC from enforcing rules or issuing orders that impose prophylactic measures against any kind of fraud with respect to security-based swap agreements.⁶ The CFMA defined "security-based swap agreements" in section 206B of the Gramm-Leach-Bliley Act as any "swap agreement . . . of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein." The SEC's Division of Enforcement is, however, granted authority to promulgate rules that prohib-

it fraud, manipulation and insider trading and enforce those rules against securities-based swap agreements under the antifraud provisions in Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. As a result, the SEC has jurisdiction over insider trading of securities-based swap agreements.

In its complaint, the SEC argued that it has jurisdiction to bring the case against Rorech and Negrin. The SEC noted that: "[t]he CDS at issue in this matter qualify as security-based swap agreements under the Gramm-Leach-Bliley Act . . . and are therefore subject to the antifraud provisions set forth in Section 10(b) of the Exchange Act and the rules promulgated thereunder."⁷

In a memorandum of law in support of his Motion for Judgment on the Pleadings filed on August 13, 2009, Rorech argues that the complaint should be dismissed as the CDS at issue does not constitute a "securities-based swap agreement."⁸ Pursuant to Rorech, the material terms of the CDS, such as the term, notional amount, fixed payments, settlement mechanics (continued on page 3)

⁴ Section 10(b) provides: "[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement (as defined in section 206B of the Gramm-Leach-Bliley Act), any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors."

⁵ Rule 10b-5 provides: "[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange . . . to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

⁶ Section 3A(b)(2) of the Exchange Act and Section 2A(b)(2) of the Securities Act provide: "[t]he SEC is prohibited from registering, or requiring, recommending, or suggesting, the registration under this title of any security-based swap agreement (as defined in Section 206B of the Gramm-Leach-Bliley Act)." Section 3A(b)(3) of the Exchange Act and Section 2A(b)(3) of the Securities Act provide: "[t]he SEC is prohibited from . . . promulgating, interpreting, or enforcing rules . . . or issuing orders of general applicability under this title in a manner that imposes or specifies reporting or recordkeeping requirements, procedures, or standards as prophylactic measures against fraud, manipulation, or insider trading with respect to any security-based swap agreement (as defined in Section 206B of the Gramm-Leach-Bliley Act)."

⁷ SEC v. Rorech, at page 49.

⁸ Memorandum of Law in Support re: Motion for Judgment On Pleadings filed by Jon-Paul Rorech (Strassberg, Richard) (Entered: 08/13/2009), at pages 9 *et seq.*

Regulation of OTC Derivatives *(continued from page 2)*

and triggering credit events, are not based on "the price, yield, value, or volatility of any security," as required by the statutory definition of "security-based swap agreement." Rorech further posits that the SEC does not have jurisdiction over the VNU bonds, as these bonds were issued by a foreign issuer and trade on a foreign exchange. Without jurisdiction over the VNU bonds, Rorech concludes, the SEC also lacks jurisdiction over the CDS that references these bonds.⁹

Negrin, in his August 19, 2009 Motion for Judgment on the Pleadings, seconds Rorech's argument and equally takes the view that the SEC lacks jurisdiction to bring its enforcement action because the CDS did not constitute a "securities-based swap agreement" as defined in the Gramm-Leach-Bliley Act.¹⁰

Beyond SEC v. Rorech and Negrin

The SEC filed the complaint against Rorech and Negrin in reliance on existing jurisdiction over securities-based swap agreements. Chairman Schapiro has publicly stated that the SEC currently has more than 50 ongoing investigations involving CDS and other derivatives-related investments, which highlights the SEC's revived focus on asserting its role in the oversight of OTC derivatives.¹¹ The SEC has also entered into a

Memorandum of Understanding with the CFTC on March 11, 2008, in order to "establish a permanent regulatory liaison and facilitate the discussion and coordination of regulatory action regarding issues of common regulatory interest."¹² The SEC and the CFTC entered into the Memorandum of Understanding to ensure complete and effective regulation of OTC derivatives, as financial innovation has meant that "novel derivative products may reflect elements of both securities and commodity futures or options, and may impact the regulatory mission of each agency."¹³ On June 22, 2009, Chairmen Gensler¹⁴ and Schapiro¹⁵ testified before the Subcommittee on Securities, Insurance, and Investment regarding the regulatory framework for OTC derivatives. Both Chairmen agreed that the SEC should have "primary responsibility for 'securities-related' OTC derivatives," including CDS, and the CFTC should have "primary responsibility for all other OTC derivatives, including derivatives related to interest rates, foreign exchange, commodities, energy, and metals."¹⁶ Both the House Agricultural Committee and the House Financial Services Committee reached agreement to work together on draft legislation when Congress returns from summer recess. On July 30, 2009, Congressman Peterson, Chairman of the House Agricultural Committee, and Congressman Frank, Chairman of the House

Financial Services Committee, released a concept paper describing the principles for OTC derivatives legislation and procedures for resolving disputes between the SEC and the CFTC over authority over new derivatives products.¹⁷

Going forward, the SEC's jurisdiction likely will grow as President Obama's plans for the "comprehensive regulation" of OTC derivatives, as released by the U.S. Department of the Treasury, are implemented.¹⁸ This will include amending the U.S. Commodities Exchange Act of 1936, as amended (the "CEA"), and the securities laws to ensure that the CFTC and the SEC "have clear, unimpeded authority to police and prevent fraud, market manipulation, and other market abuses involving all OTC derivatives."¹⁹ The plans for reform also provide that the CFTC and the SEC should have the power "to impose record-keeping and reporting requirements (including an audit trail) on all OTC derivatives."²⁰ While it remains to be seen how the CEA and the securities laws will be amended to implement the President's plans and to provide both agencies with the tools to effectively protect the markets from fraud in connection with OTC derivatives, the outcome of SEC v. Rorech likely will receive much attention in determining the effectiveness of the presently existing tool set. ■

⁹ Ibid, at page 15 *et seq.*

¹⁰ Memorandum of Law in Support re: Motion for Judgment on Pleadings filed by Renato Negrin (Fang, Linda) (Entered: 08/19/2009), at pages 8 *et seq.*

¹¹ Mary Schapiro (SEC Chairman). "Speech by SEC Chairman: Address to the Society of American Business Editors and Writers." (Date: 04/27/09). Available at <http://www.sec.gov/news/speech/2009/spch042709mls.htm>

¹² Memorandum of Understanding between the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission regarding Coordination in Areas of Common Regulatory Interest, dated March 11, 2008. Available at http://www.sec.gov/news/press/2008/2008-40_mou.pdf

¹³ Addendum to the Memorandum of Understanding.

¹⁴ Gary Gensler (CFTC Chairman). "Testimony before the Subcommittee on Securities, Insurance, and Investment." (Date: 6/22/09). Available at <http://cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opagensler-4.pdf>

¹⁵ Mary Schapiro (SEC Chairman). "Testimony Concerning Regulation of Over-The-Counter Derivatives before the Subcommittee on Securities, Insurance, and Investment." (Date: 6/22/09). Available at <http://sec.gov/news/testimony/2009/ts062209mls.htm>

¹⁶ Ibid.

¹⁷ Collin Peterson (Chairman of the House Agricultural Committee) and Barney Frank (Chairman of the House Financial Services Committee). "Description of Principles for OTC Derivatives Legislation." (Date: 7/30/09). Available at http://agriculture.house.gov/inside/Legislation/111/otc_principles_final_7-30.pdf

¹⁸ U.S. Department of the Treasury. Financial Regulatory Reform - A New Foundation: Rebuilding Financial Supervision and Regulation. (Date: 6/17/09). Available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

¹⁹ Ibid, at page 48.

²⁰ Ibid, at page 48.

SEC Speaks: "We are the Investor's Advocate"

In a recent speech, SEC Chairman Mary Schapiro referenced a framed quote that is prominently displayed outside the Chairman's Office from former Chairman (and later Supreme Court Justice) William O. Douglas; it says, "We are the investor's advocate." Chairman Schapiro then went on to note that "While not framed, and perhaps not as elegant, there is a sign taped to the door of my office, for all to read and ponder as they enter to present a proposal or an idea; it says, 'How does it help investors?'" In recent months, Chairman Schapiro has outlined various reforms the SEC will be considering to improve investor protection, restore investor confidence in both the SEC and the securities markets, and ensure that the SEC is a strong and effective advocate for investors. Of particular interest to private funds, the SEC (i) has expressed support for the Obama Administration's "Private Fund Investment Advisers Registration Act of 2009" which would require investment

advisers to "private funds" with more than \$30 million of assets under management to register with the SEC; (ii) has proposed a rule under the Advisers Act intended to curtail pay-to-play practices by investment advisers to public pension funds; (iii) is examining the broker-dealer and investment adviser regulatory regimes and assessing how they can best be harmonized and improved for the benefit of investors; (iv) has proposed significant changes to the custody requirements for registered investment advisers; and (v) is working on improving the SEC's risk-based oversight of broker-dealers, investment advisers and mutual funds and is currently working on an initiative to identify the key data points that would facilitate an improved risk-based oversight methodology to allow the staff to identify and focus on those firms presenting the most risk. ■

Placement Agents and Public Pension Plans: The Changing Landscape

MARCO V. MASOTTI, AMRAN HUSSEIN, GITANJALI WORKMAN AND ADAM HAHN

Placement agents are commonly used by investment managers to perform a variety of services, including introducing managers to prospective investors, advising managers on marketing strategies and assisting managers in developing marketing materials. The role of placement agents in the private investment funds industry has recently come under increased scrutiny, with a particular focus on the use of placement agents to secure fund commitments from public pension plans.

The nationwide spotlight turned to this issue in March 2009 when a New York grand jury issued a 123-count indictment against Henry "Hank" Morris, a chief political aide and fundraiser for the former New York State Comptroller Alan Hevesi, and David Loglisci, the former chief investment officer of New York State's Common Retirement Fund ("NYSCRF"), one of the largest public employee pension plans in the United States. The indictment followed a two-year investigation by the New York State Attorney General Andrew Cuomo into alleged corruption involving New York's public pension plans. The indictment charged Morris and Loglisci with coercing fund managers seeking to obtain commitments from NYSCRF into using placement agents controlled by Morris, associates of Morris or long-time political supporters of Hevesi. The New York Attorney General alleges that Morris often kept hidden from NYSCRF staff and the fund managers that hired him, his conflicting roles as a political aide to the Comptroller, a placement agent and a de facto NYSCRF investment manager. According to the New York Attorney General, Morris, Loglisci and their associates earned tens of millions of dollars in placement fees in connection with securing from NYSCRF over \$5 billion of commitments to more than 20 private equity funds, hedge funds and funds-of-funds during Hevesi's reign as Comptroller.

In response to the Morris/Loglisci indictment and the ongoing Cuomo investigation, on April 22, 2009, the New York State Comptroller, on behalf of NYSCRF, adopted a new policy titled "Placement Agent Disclosure Policies and Procedures of the Office of the State Comptroller" (the "NYSCRF Policies"), which bans the use of placement agents in connection

with any investment made by NYSCRF. Fund managers are required to comply with the NYSCRF Policies if they have direct or indirect investment management relationships with NYSCRF. Under the NYSCRF Policies, a fund manager is required to represent, in writing, to NYSCRF that (i) the fund manager has not used any third-party intermediary to procure the commitment from NYSCRF (regardless of the form of compensation paid to the intermediary) and (ii) no benefit has been provided to any NYSCRF consultants or advisors or any of their affiliates. Failure of the fund manager to provide the written representations permits NYSCRF to unilaterally terminate the investment relationship, without any liability or consequence to NYSCRF, in a manner consistent with the asset-type being managed (e.g., if the investment is in private equity, NYSCRF can terminate its obligation to provide future capital contributions and if the investment is in a hedge fund, NYSCRF may immediately

redeem its investment).

Although several other public pension plans already had policies in place regarding the use of placement agents, NYSCRF's new policy changed the landscape by imposing an outright ban on the use of placement agents to secure a commitment from NYSCRF, including properly registered broker-dealers. To date, while a few other public pension plans have followed NYSCRF's approach and banned the use of placement agents, the majority of pension plans that have adopted new or revised policies have chosen not to ban placement agents but instead have sought increased transparency by imposing heightened disclosure requirements on investments managers that want to do business with the public pension plans. The following is a brief summary of states, cities and public pension plans with laws or policies governing the use of placement agents in connection with public pension plan investments:

CALIFORNIA :

California Public Employees' Retirement System (CalPERS): Adopted a new policy in May 2009 that requires heightened disclosure. A fund manager must disclose the following information to CalPERS prior to closing on a CalPERS' investment (or prior to any substantive amendment to an existing fund document): (i) whether the fund manager is using a placement agent for the CalPERS' investment; (ii) the placement agent's resume; (iii) a description of the placement agent's compensation; (iv) a statement of the placement agent's services; (v) a copy of the engagement agreement; (vi) the names of any CalPERS board members, employees, or consultants who suggested retention of the placement agent; (vii) a statement detailing the placement agent's registration with the SEC or FINRA, or explanation of why registration is not required; and (viii) a statement of whether the placement agent is a registered lobbyist with any state or national government.

California State Teachers' Retirement System (CalSTRS): Pursuant to a policy adopted in November 2006, a manager is required to disclose, in writing, to CalSTRS all third party relationships that assisted in securing CalSTRS' commitment and any fees paid to such third parties as a result of such relationship.

CONNECTICUT :

Since 2000, Connecticut law has prohibited payments of finder's fees to third parties that merely act as "door openers" to connect private firms with the State for investment transactions. Payments of placement agent fees to firms performing legitimate marketing and due diligence services are allowed, but the payments and the identity of the placement agent must be fully and publicly disclosed.

On May 4, 2009, the Connecticut State Treasurer instituted two additional disclosure requirements for funds-of-funds. First, a funds-of-funds manager is required to provide additional disclosures regarding third-party payments made by the managers of the funds in which the funds-of-funds invests in connection with any commitment from Connecticut Retirement Plans and Trust Funds. Second, if a funds-of-funds manager discloses payments to placement agents in connection with an investment contract with the State, then the fund manager must also disclose whether the placement agent paid any sub-agents with respect to the engagement.

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Placement Agents and Public Pension Plans *(continued from page 4)*

ILLINOIS:

Effective as of April 2009, a new law prohibits placement fees and makes it a business offense to "retain a person or entity to attempt to influence the outcome of an investment decision of or the procurement of investment advice or services of" a pension plan under operation of the State code (which includes both state and municipal funds).

LOS ANGELES:

Los Angeles Employees' Retirement System (LACERS): By policy adopted in April 2009, managers are required to disclose the identity and fees of all third-party marketers and/or individuals in connection with any contract between the manager and LACERS.

Los Angeles Fire and Police Pension Plan (LAFPP): By policy adopted July 23, 2009, any person or entity that seeks to be and/or is hired to provide goods and/or services to LAFPP will be required to disclose information about the use of hired intermediaries and any contributions, payments or gifts made to elected or appointed officials or any candidates for office (including any organizations affiliated with such officials or candidates). The policy applies to all agreements that are entered into after July 23, 2009 and existing agreements, if after July 23, 2009: (i) the term of the existing agreement is extended; (ii) there is any increased commitment of funds by LAFPP; or (iii) there is an amendment to the substantive terms of the existing agreement.

NEW JERSEY:

Since 2005, New Jersey law has required investment firms engaged with the State to disclose the identity and address of any third party intermediaries used in connection with New Jersey public pension plan commitments, the services provided, the compensation arrangement and the total dollar amount of payments made. On July 9, 2009, the State Investment Council approved new standards for placement agents, including requiring placement agents to be registered with the SEC, FINRA and/or state regulators and requiring the top managers at the agent's firm to have a minimum of three years of experience in the securities industry.

NEW MEXICO:

Beginning on June 19, 2009, any fund manager that obtains an investment from the State Investment Council, the Public Employees' Retirement Board or the Educational Retirement Board is subject to new statutory disclosure laws targeting the use of placement agents. Fund managers are required to disclose the identities of any third-party who renders services in connection with obtaining the investment from the New Mexico pension plan and the amount of any fees paid for those services.

State Investment Council: In May 2009, the State Investment Council banned the use of any placement agent; however, in July 2009, the ban was modified to allow fund managers to generally use placement agents so long as those agents do not represent the managers in connection with investments solicited from the State Investment Council, the State Investment Office or its Private Equity Investment Advisory Committee. In addition, any fund manager that pays a placement agent a fee in excess of \$50,000 in connection with an investment by the State Investment Council is now subject to extensive public disclosure requirements including, but not limited to, the identity of the third parties and a description of services provided.

Educational Retirement Board: In May 2009, the Educational Retirement Board instituted a six-month ban on the use of placement agents while it drafts new disclosure rules. On June 2, 2009, the Educational Retirement Board announced that it would not permanently ban the use of placement agents. It has not yet released new disclosure rules.

NEW YORK CITY:

Although the New York City Comptroller has asked the New York City pension plans to adopt the principles set forth in Attorney General Cuomo's Public Pension Plan Reform Code of Conduct (see description next to this chart), to date, none of the five NYC plans has adopted it.

NEW YORK STATE:

New York State Common Retirement Fund (NYSCRF): In April 2009, NYSCRF adopted a policy (see description on page 4) banning the use of placement agents, lobbyists and other third-party intermediaries in connection with investments by NYSCRF. The policy requires the fund manager to make certain representations confirming that that no placement agent has been used.

New York State Teachers' Retirement System (NYSTRS): On May 21, 2009, NYSTRS became the first public pension plan to officially adopt Attorney General Cuomo's Public Pension Plan Reform Code of Conduct (see description next to this chart).

The initial catalyst for the increased attention being paid nationwide to the role of placement agents was the alleged corruption, lobbying and kickback schemes that were uncovered by the New York Attorney General's investigation. However, as described in the summary chart, the rules that have been adopted thus far by state legislators and pension plans do not distinguish between the role of an unaffiliated placement agent and a politically connected one.

Although the Morris/Logisci indictment did not charge any fund manager with wrongdoing, on May 1, 2009, the New York Attorney General's office announced that it had issued subpoenas to more than 100 managers that have conducted business with New York pension plans and that Cuomo had assembled a nationwide task force with 36 other state attorney generals to share information about ongoing investigations involving public pension plans. To date, the New York Attorney General's Office has announced that it has entered into separate agreements with The Carlyle Group, Riverstone Holdings, LLC and Pacific Corporate Group Holdings, LLC pursuant to which Cuomo agreed to suspend the investigation against each fund manager and each fund manager agreed to (i) adopt Cuomo's Public Pension Plan Reform Code of Conduct (the "Code"), (ii) make certain payments to New York State and (iii) use its best efforts to cooperate with Cuomo's investigation of the marketing of investments to public pension plans. By signing on to the Code, Carlyle, Riverstone and Pacific Corporate Group have agreed to, among other things, not use any placement agents in connection with obtaining commitments from public pension plans nationwide. In addition to these three fund managers, the Code has also been adopted by the New York State Teachers' Retirement System, which means that it will apply to any fund manager that obtains a new commitment from the New York State Teachers' Retirement System. Several other states, cities and pension plans are currently considering requiring the fund managers they work with to adopt rules analogous to the Code in order to obtain access to their assets.

The Code sets forth policies and procedures governing a fund manager's interactions with public pension plans through placement agents. The Code's intended purpose is to prevent "pay-to-play" practices (i.e., the ability of an investment manager to monetarily contribute to the political campaigns of those who control the public pension purse strings in an effort to influence the public pension's investment-making decisions in the investment manager's favor).

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Placement Agents and Public Pension Plans *(continued from page 5)*

OKLAHOMA:

Oklahoma Pension Oversight Commission (OPOC): On June 17, 2009, OPOC adopted a policy requiring full disclosure of the use of placement agents used to obtain state funds and urged all Oklahoma public pension boards to adopt similar policies.

Tobacco Settlement Board of Investors: On June 17, 2009, the Tobacco Board adopted a similar policy to that adopted by OPOC that requires full disclosure of the use of placement agents used to obtain state funds and requires the disclosure by all bidders seeking to obtain funds from Oklahoma's share of the national tobacco settlement.

SAN FRANCISCO:

San Francisco Employees' Retirement System (SFERS): SFERS has included a new requirement that fund managers disclose any financial relationships they have with placement agents in their response to SFERS Request for Proposals.

TEXAS:

Teacher Retirement System of Texas (TRS): On June 16, 2009, TRS adopted a policy, effective July 1, 2009, restricting TRS from paying any placement fees and mandating that no investments may be made if non-registered placement agents are used or if placement fees are shared with non-registered persons.

Specifically, the Code:

- prohibits the use of placement agents and lobbyists by the fund manager to establish a relationship with, or obtain access to, any public pension plan;
- bans the fund manager from using placement agents to secure public pension plan commitments or to continue with an existing investment by a public pension plan if the fund manager, its executives or their immediate family members make campaign contributions above \$300 to officials of that public pension plan (unless the executive or immediate family member was entitled to vote for such office at the time of their contributions and the contributions do not exceed, in the aggregate, the \$300 threshold or if the contributions exceed \$300, so long as such contributions were made within the 14 days immediately prior to the effective date of the Code) and requires that the fund manager adopt internal procedures to ensure compliance with this particular mandate within 90 days of adopting the Code;
- requires the fund manager to disclose actual and apparent conflicts of interest (with disclosure required to be made to the public pension plan, but if that is ineffective, to the New York Attorney General or other appropriate law enforcement official), including with respect to any federal and state campaign contributions, names of fund personnel whose duties include contact with public pension plan officials and any payments to broker-dealers or other

placement agents (including contributions of any amount to officials within the two calendar years prior to the closing of an investment with the public pension fund, and contributions made within the last calendar year if a fund manager is currently engaged by the public pension fund to perform investment management services for compensation); and

- increases the fiduciary standard of care with regard to the fund manager's interactions with public pension plans and their officials and advisors (including a two-year ban on the hiring of a former public pension plan official if that official will have any interaction whatsoever with that public pension plan going forward, and a restriction on gifts provided to public pension plan employees to be limited to a nominal value).

It is important to note that the Code applies not only to a fund manager's interactions with New York pension plans but to interactions with all public pension plans nationwide.

The use of placement agents in connection with public pension plan investments has also received the attention of the U.S. Securities and Exchange Commission (the "SEC"). The SEC has filed civil complaints against several individuals who are also subject to indictment at the state level, including Henry "Hank" Morris, David Loglisci and Saul Meyer (the founder of Aldus Equity Capital). The Cuomo investigation, coupled with the related SEC-civil complaints, further combined with nationwide reaction by state

and city public pension plans has sent a clear signal to the fund industry that there will likely be changes in the dynamic between public pension plans, placement agents and fund managers. In July 2009, a group of more than 20 placement agents started a lobbying group to address the various regulatory developments around the nation concerning the use of placement agents in the industry. One of the first issues this lobbying group is tackling is the SEC's recently proposed Rule 206(4)-5 under the U.S. Investment Advisers Act of 1940, as amended (the "Advisers Act"), entitled "Political Contributions by Certain Investment Advisers" (the "Proposed Rule"). The Proposed Rule seeks to impose three significant restrictions on "pay-to-play" practices of investment managers that seek to manage money for state and local government plans:

- **Ban on Use of Placement Agents:** First, the Proposed Rule would prohibit fund managers from paying third parties to solicit government entities for advisory business. This prohibition on payments to third party solicitors would not apply to solicitations on behalf of an investment adviser by a person who is a "related person" of the manager, any of the related person's employees if the related person is a company, or any employees, executive officers, or partners of the investment manager. A "related person" is defined as any person, directly or indirectly, controlling or controlled by the investment manager, and any person that is under common control with the investment manager.
- **Two-Year Compensation Restrictions:** Second, the Proposed Rule would prohibit a fund manager from receiving compensation for providing advisory services to a government entity for a two-year period after the fund manager or certain of its executives makes a political contribution to a public official of a government entity that is in a position to influence the award of advisory business. There are two exceptions to this prohibition: (a) contributions of \$250 or less, per election, to officials the contributor is entitled to vote for are permitted; and (b) contributions of \$250 or less, per election, to officials the contributor is not entitled to vote for are also permitted so long as the manager discovers and returns the contribution within the time periods set forth in the Proposed Rule. The Proposed Rule does, however, provide that in certain limited *(continued on page 7)*

Placement Agents and Public Pension Plans *(continued from page 6)*

circumstances, a fund manager may apply for an order exempting it from the two-year compensation ban.

- **Ban on Soliciting and Coordinating Political Contributions:** Third, the Proposed Rule prohibits a fund manager and certain of its executives from soliciting or coordinating contributions to an official of a government entity or payments to a political party of a state or locality to which or where the fund manager is seeking to provide investment advisory services to a government entity.

The Proposed Rule would apply to any investment adviser registered (or required to be registered) with the SEC, or unregistered in reliance on the "private adviser" exemption available under Section 203(b)(3) of the Advisers Act. The Proposed Rule would not apply, however, to investment advisers registered with the state securities authorities and unregistered investment advisers relying upon the intrastate exemption available under Section 203(b)(1) of the Advisers Act. Please see our August 11, 2009 client alert entitled "*SEC Proposes 'Pay to Play' Rule Regarding Political Contributions by Certain Investment Advisers*" for further information on this topic. As the Proposed Rule was only released in August 2009 and the comment period continues until October 6, 2009, it is uncertain whether it will be adopted in its current form. However, given the intense scrutiny that has been given to this issue over the past eight months and the actions that have already been taken by various legislators and pension plans, it is likely that the SEC will adopt a final rule that includes many of the requirements set forth in the Proposed Rule.

In the wake of these developments, fund managers should evaluate their use of placement agents and consider taking the following actions if they deem it appropriate in their particular circumstances:

- Assess the fund manager's placement agent exposure during at least the last five years and be prepared to provide regulators with documentation about current placement agent relationships.

- Review current practices and procedures with respect to public pension plans. Fund managers should maintain accurate records of their interactions with public pension plans, as any potential consequence resulting therefrom is not likely to occur until years later.
- Adopt a written due diligence process to be followed each time a placement agent is engaged and maintain records of such due diligence. For example, always confirm that placement agents are properly registered (especially critical given that the New York Attorney General's recent subpoena of over a 100 investment managers was partially based upon their alleged use of unregistered placement agents).
- Re-examine existing placement agent agreements and ensure that all placement agent agreements going forward have appropriate representations by placement agents on compliance with applicable law and policies. Also ensure that such agreements permit modification in case of a "change in law."
- Establish internal ethics and compliance manuals that provide employees with guidance on restrictions related to gifts, political contributions and the diligence process employed when soliciting investments from public pensions. Ensure regular updates and review of such policies; and take effective action upon any determination of non-compliance with such policies.
- Be vigilant when soliciting investors in new geographic locations and pay attention to local rules and procedures.
- Provide limited partners with disclosure of compensation paid to placement agents while being cognizant of confidentiality obligations.

Recent Litigation Affecting Private Funds

DUE DILIGENCE

South Cherry Street, LLC v. Hennessee Group LLC, Elizabeth L. Hennessee, Charles A. Gradante.

On July 14, 2009, the Second Circuit Court of Appeals affirmed the District Court for the SDNY's dismissal of certain claims brought by South Cherry Street, LLC ("South Cherry") against Hennessee Group LLC and others ("Hennessee Group") relating to South Cherry's investment in Bayou Accredited Fund, L.L.C. ("Bayou Accredited") - a hedge fund that the SEC later determined was a Ponzi scheme. South Cherry invested in Bayou Accredited based upon the recommendation of the Hennessee Group, whose business it is to scrutinize and evaluate hedge funds. When the Bayou Accredited frauds were exposed, South Cherry filed suit against Hennessee Group in the Southern District of New York for securities fraud under Section 10(b) of the Exchange Act and Rule 10b-5, as well as breach of contract for allegedly failing to perform due diligence. The Second Circuit first agreed that the breach of contract claim was rightly dismissed because the oral agreement between South Cherry and Hennessee could not be performed within one year, and thereby violated New York's Statute of Frauds. The court then turned to the scienter requirement in the Private Securities Litigation Reform Act of 1995. The questions before the court were whether the complaint created "a strong inference of scienter" and "whether an inference of scienter is at least as compelling as any opposing inference of nonfraudulent and nonreckless intent." Despite South Cherry's statement in the complaint that Hennessee Group "knowingly or recklessly" made untrue statements or omitted material facts, the court said, "nowhere in the complaint is there any allegation that Hennessee Group had knowledge that any representation it made as to the records or circumstances of Bayou Accredited, or its predecessor Bayou Fund, was untrue." Instead, the court said, the complaint emphasized that Hennessee Group "would" have learned of the fraud if it had performed the "due diligence" it promised. "Nor, to the extent that South Cherry sought to allege recklessness, does the complaint contain an allegation of any fact relating to Bayou Accredited that (a) was known to Hennessee Group and (b) created a strong inference that Hennessee Group had a state of mind approximating an actual intent either to relay false or misleading information about Bayou Accredited or to aid in the fraud being perpetrated by the Bayou Accredited principals."

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Indemnifying Portfolio Company Directors: Matching Expectations

GIULIANNA K. RUIZ

Investment funds commonly request and expect that key investment professionals serve as directors on the boards of the portfolio companies in which the funds invest. Fund professionals expect to serve on such boards, provided that they are fully protected with respect to actions taken as board members, and will look not only to the portfolio company for indemnification protection, but also to the fund itself as a backstop in case the portfolio company indemnification provisions do not provide sufficient coverage. Recent case law in Delaware brings to light the need to closely diligence indemnification and expense advancement coverage at the portfolio company-level and ensure that in the attempt to provide comfort to its investment professionals, the fund's indemnification and expense advancement coverage do not inadvertently become primary coverage.

Advancement v. Indemnification Rights

As a preliminary matter, it is important to note that although practitioners commonly use the word "indemnity" to refer to both the right of ultimate indemnification (i.e., reimbursement for any losses, including, generally, expenses and fees, incurred with respect to a claim against such person) and the right to receive an advancement of fees and expenses incurred during the defense of an indemnifiable claim, this broad use of "indemnity" does not always result in expected coverage. For example, a Delaware Chancery Court decision, *Schoon v. Troy Corporation*¹ (discussed in more detail below) serves to reinforce the lesson that the interrelation between indemnification provisions and advancement provisions should not be taken for granted. The *Schoon* court noted that in the bylaws at issue, "the clear separation of the indemnification and advancement provisions precludes the interpretation" that the advancement provision is simply a subsidiary provision to indemnification, a position that other courts have taken.² Another more recent case, also discussed in more detail below, *Sodano v. American Stock Exchange LLC*,³ underscores the need to make sure indemnification provisions are clear and unambiguous with respect to the type of protection afforded. In *Sodano*, while ultimately holding that the term "indemnity" did encompass advancement rights, the court relied on state contract interpretation

provisions to look outside of the indemnity provision at issue and take into consideration the expectations of the parties – a position that many courts will not take. To preempt any controversy, which will likely only surface at the time of litigation, investment funds should make sure that in reviewing their own indemnity provisions and in reviewing portfolio company indemnity provisions, where advancement rights are intended, such rights should be stated clearly.

Portfolio Company Indemnification Provisions – Protecting Against Unilateral Changes

Schoon v. Troy. *Schoon v. Troy Corporation*⁴ provides several lessons on how to make sure a fund's board nominee is adequately protected by the portfolio company. In *Schoon*, the court held that a former director, a designee of a major stockholder of the corporation, was not entitled to advancement of legal fees and expenses in defending against an action brought by Troy. Troy had filed fiduciary duty-based claims against both William J. Bohnen, a former director, and Richard W. Schoon, a current director and successor to Bohnen. While Bohnen served as a director, the corporation's bylaws had provided for indemnification rights and advancement rights to current and former directors. After Bohnen's resignation but prior to bringing the claim at issue, the Troy board of directors, other than Schoon, approved amendments to Troy's bylaws that effectively deleted the reference to former directors and provided that only current directors were entitled to advancement rights. The amendments further provided that no advancements would be made in respect of any claims initiated by the indemnitees against the corporation unless otherwise approved by the board.

The issue argued in *Schoon* was whether Bohnen's rights to advancement vested when he took office, before the adoption of the bylaw amendments, and therefore, as a vested contract right, could not be unilaterally terminated without Bohnen's consent. Contrary to Bohnen's expectations, the court held that the right to advancement vested at the time a person was named in a potentially indemnifiable claim. In Bohnen's case, Bohnen was not named *(continued on page 9)*

Recent Litigation Affecting Private Funds

(continued from page 7)

In the Matter of Hennessee Group LLC and Charles J. Gradante.

On April 22, 2009, in a settled administrative proceeding, the SEC issued an order finding that Hennessee Group LLC, a registered investment adviser that acts as a hedge fund consultant ("Hennessee"), and its principal, Charles J. Gradante, did not perform key elements of the due diligence that they had represented they would conduct prior to recommending that their clients invest in four hedge funds managed by Bayou Management LLC ("Bayou") (funds that were later determined by the SEC to be a fraud). According to the order, Hennessee routinely represented to clients and prospective clients that it would not recommend investments in hedge funds that did not satisfy all phases of its due diligence evaluation. According to the findings, approximately 40 clients invested millions of dollars in the Bayou hedge funds after Hennessee recommended those investments. The order alleges that most of the money was lost through trading or dissipated by Bayou's principals, who defrauded their investors by fabricating Bayou's performance in client account statements and year-end financial statements. The SEC's order stated that Hennessee and Mr. Gradante, in their capacities as investment advisers, owed fiduciary duties to their clients to perform the services that they represented they would provide and to disclose all material departures from the representations that they made to their clients. According to the order, Hennessee and Mr. Gradante failed to conduct the portfolio and trading analysis that it had advertised to clients. Instead of analyzing Bayou's results and processes through a review of Bayou's historical trading methods to determine whether the fund was successfully executing its purported day-trading strategy, the order found that Hennessee and Mr. Gradante decided not to perform any analysis after Bayou refused to produce its trading data. The order also found that despite conflicting reports from Bayou about the identity of its independent auditor, Hennessee and Mr. Gradante failed to verify Bayou's relationship with its auditor. According to the order, Hennessee and Mr. Gradante also failed to respond to red flags concerning Bayou that came to their attention while they were monitoring Bayou on behalf of their clients. The SEC's order found that Hennessee and Mr. Gradante willfully violated Section 206(2) of the Advisers Act, which prohibits any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client, and that Mr. Gradante caused Hennessee's violations of Section 206(2) of the Advisers Act. Hennessee and Mr. Gradante, without admitting or denying the findings, agreed to pay \$814,644 in disgorgement and penalties.

(continued on page 9)

¹ 948 A.2d 1157 (Del Ch. 2008).

² Id. at 1167-68.

³ 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008).

⁴ 948 A.2d 1157 (Del Ch. 2008).

Indemnifying Portfolio Company Directors *(continued from page 8)*

in the claim until after the bylaw amendment was adopted and therefore the amended bylaws controlled and Bohnen was not entitled to advancement of his legal fees and expenses.

The outcome in Schoon was a surprise to boards and their advisers and had many directors reviewing their companies' charters and bylaws to assess their rights of indemnification and advancement of expenses in its aftermath. Recent amendments to the Delaware General Corporation Law have, however, largely mooted Schoon by an amendment to Section 145 (relating to the indemnification of officers, directors, employees and agents) that prohibits the elimination or impairment of a right to indemnification or advancement of expenses arising under the company's charter or bylaws after the occurrence of the act or omission that is the subject of the proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred. These amendments became effective August 1, 2009. Note, however, that there is no such similar provision under the Delaware Uniform Limited Partnership Act or the Delaware Limited Liability Company Act.

Practical Considerations:

- Identify the document granting the right to indemnification and advancement. If the indemnification and advancement rights appear in the charter of a corporation, those rights will be more difficult to amend (i.e., will likely require a shareholder vote). Note however that if not already included in the charter, such inclusion will be equally difficult to implement.
- Make sure the provisions protect the interests of former directors. For example, from and after August 1, 2009, for Delaware corporations, ensure that there is no provision authorizing the company to eliminate or impair indemnification or advancement provisions after the occurrence of an act or omission for which indemnification or advancement of expenses is available. For non-Delaware corporations or other types of entities, make sure that either the governing law provides protection against retroactive unilateral amendments to indemnification or advancement provisions or that such protection is explicit in the entity's constituent documents.
- Request that the portfolio company's constituent documents provide that the time of vesting of indemnification and advancement

rights be at the time a director takes office.

- For added protection, require a separate agreement between the portfolio company and the director, turning such director's rights to indemnification and advancement into a contractual obligation that cannot be modified without the director's consent.

Indemnification Provisions at the Fund Level – When Is It Too Much?

"To the Fullest Extent Permitted by Law." Funds recognize that their investment professionals expect to be properly indemnified where they act as portfolio company directors at the request of the fund. Assurance of full protection has long been an accepted inducement for individuals to take on board responsibilities. To make sure investment professionals are granted the indemnification coverage they expect, fund indemnification provisions commonly state that the fund will provide indemnification "to the fullest extent permitted by law." Both the fund and the director generally expect, however, that in a claim against the director for services as a board member of a portfolio company, the portfolio company itself will have the primary obligation to indemnify the board member. To make sure reality matches expectations, the fact that the fund is secondarily liable to the portfolio company's indemnification obligation should be clearly stated such that the fund will be the subrogee to such investment professional's rights to indemnification from the portfolio company. Delaware Chancery court cases *Levy v. HLI Operating Company, Inc.*⁵ and *Sodano v. American Stock Exchange*⁶ demonstrate the need for these clarifications – each is discussed in turn in more detail below.

Levy v. HLI. In *Levy v. HLI Operating Company, Inc.*, former outside directors sued HLI to obtain indemnification for monies paid in settlement on their behalf by JLL Fund, a stockholder of HLI that had designated the plaintiff directors. In this case, there was no question that the directors were entitled to indemnification by HLI pursuant to HLI's bylaws, personal indemnification agreements and under a bankruptcy reorganization plan. However, HLI argued that because JLL Fund paid the settlement, the directors did not suffer an actual loss – the court agreed, holding that the directors were not real parties-in-interest. Instead, the court held that the appropriate cause of action was by JLL Fund for contribution against the corporation, but only for their equitable share of the amount of indemnification the fund *(continued on page 10)*

Recent Litigation Affecting Private Funds

(continued from page 8)

DELAWARE LLC AMENDMENT PROVISIONS

In re NextMedia Investors, LLC.

On May 6, 2009, the Delaware Court of Chancery granted a motion for summary judgment requesting an order of dissolution of NextMedia Investors, LLC, a Delaware limited liability company ("NextMedia"), based upon an analysis of the amendment provisions of NextMedia's limited liability company agreement (the "LLC Agreement"). Petitioners, two members of NextMedia, refused to consent to an amendment that would extend the dissolution date of NextMedia by four years. The amendment was overwhelmingly approved by other members of NextMedia. Petitioners brought the action in order to have NextMedia dissolved in accordance with the original terms of the LLC Agreement. At issue was language in the LLC Agreement that provided that "without the consent of each Member to be adversely affected" certain sections of the LLC Agreement, including the dissolution date, could not be amended "to affect adversely any Member." NextMedia argued, among other points, that the petitioners were not entitled to summary judgment because petitioners had "not provided the court with a factual basis to conclude that they were adversely affected" by the amendment, and as such, there was a triable issue of fact. In this regard, NextMedia offered affidavits from its officers indicating that a liquidation of its assets upon the original dissolution date would have resulted in no distributions to its equity holders because of the depressed market prices of those assets. In rejecting this argument, the court stated that whether petitioners were to be adversely affected for purposes of the relevant amendment language "is necessarily a before-the-fact question - a company cannot determine who is entitled to vote on an action by first carrying out the action and then seeing who is adversely affected." The court added that petitioners should not be required to show they were entitled to vote on the proposed amendment through factual evidence. Rather, "the question of who is entitled to vote is best judged by who can be reasonably expected to be adversely affected." The court continued that whether an amendment triggers the individual approval right at issue "depends not on an empirical, factual assessment of whether a member is correct about the effect of a change in the contract, but on whether the proposed contractual amendment would alter an economically meaningful term." The court concluded that an extension of the dissolution date would alter a materially important economic term *(continued on page 10)*

⁵ 924 A.2d 210 (Del Ch. 2007).

⁶ 2008 Del. Ch. LEXIS 92 (Del. Ch. July 15, 2008).

Indemnifying Portfolio Company Directors *(continued from page 9)*

overpaid, i.e., half the monies expended in the settlement on behalf of the plaintiff directors. In addition, HLI argued, and the court agreed, that because the JLL director representatives never had a viable claim for indemnification, advancement of fees and expenses was not appropriate and should be repaid to HLI.⁷

At issue in Levy was that JLL Fund's partnership agreement provided that JLL Fund would indemnify its director designees "to the fullest extent permitted by applicable law,"⁸ but did not provide any direction on how the indemnification liabilities on third party board activities would be divided with such third party. The court differentiated the claims between contribution and subrogation, noting that only in a subrogation claim does the subrogee (in this case, JLL Fund) "stand in the shoes" of the subrogor (the plaintiff directors) and may therefore "demand full payment from another party primarily responsible for the loss which the [subrogee] both insured and reimbursed." Critical to bringing a successful claim for subrogation is showing that the subrogee was only secondarily liable for the subrogor's loss, that another party (the portfolio company) bore primary responsibility for the loss and that by discharging the loss, the subrogee simultaneously extinguished the portfolio company's liability to the subrogor.⁹ The Levy court relied on the opinion in *Chamison v. Healthtrust, Inc.*,¹⁰ where the court observed that the Delaware General Corporation Law did not create a "primary-secondary" hierarchy among indemnitors and therefore "as a general rule, absent of contractual language to the contrary, two insurers who insure the same person for the same risk must share the loss."¹¹

Sodano v. American Stock Exchange. In *Sodano v. American Stock Exchange LLC*, Salvatore Sodano, the former Chief Executive Officer and chairman of American Stock Exchange LLC ("Amex"), sought advancement of legal expenses from Amex in connection with defending against securities-related claims with respect to his actions during his tenure at Amex. Sodano had been an executive at the National Association of Securities Dealers, Inc. ("NASD"), the parent company of Amex during the time period at issue, and it was at NASD's request that Sodano took office at Amex. Sodano was entitled to indemnification from both NASD and Amex and at issue was whether NASD was only secondarily liable for the advancement of Sodano's legal expenses. The NASD certificate of incorporation provided that any advancement obligations of NASD with respect to any person who is or was serving at its request as a director or officer of

another entity was to be reduced by any amounts Sodano collected as indemnification or advancement from such other entity.¹² Amex argued that, like in Levy, Amex and NASD were co-indemnitors, each responsible for the advancement of 50% of Sodano's legal expenses. The court, however, disagreed, and held that the express language in NASD's charter "created a hierarchical obligation" such that Amex was primarily liable for advancement obligations.¹³ The court noted that such language implied "a duty on behalf of Sodano to seek advancement from the Amex and to reduce the NASD's obligations by the amount Sodano may actually collect from the Amex" with the "hierarchical nature of the obligations mirror[ing] the nature of an individual's service." The court noted that "[t]his interpretation therefore captures the relevant business dynamic."¹⁴

Practical Considerations:

- Make sure that the "primary-secondary liability hierarchy" between the portfolio company and the investment fund is clearly delineated. For example, include a proviso in the indemnification provision that the investment professional serving as a portfolio company board member or officer should first look to the portfolio company for portfolio company services-related claims.
- Consider including an acknowledgement that if the fund discharges the director's board-related claims even though it is only secondarily liable, the director subrogates its rights to claim indemnification from the portfolio company to the fund.
- For added protection, set forth the "primary-secondary liability hierarchy" as between the portfolio company and the investment fund in a clear, coordinated manner in indemnification contracts at both the portfolio company level and the investment fund level.

Investment funds and their professionals are aligned in their interest to make sure fund professionals are appropriately covered with respect to portfolio company board or officer participation. The expectations are clear – portfolio companies should be primarily liable, with the fund secondarily liable only to ensure that the investment professional has "backstop" coverage. To this end, it is important not only to establish this hierarchical relationship, but also to take steps to prevent a portfolio company from unilaterally changing this relationship. ■

⁷ Levy at 218. ¹⁰ Id. at 221.

⁸ Id. at 216. ¹¹ 735 A.2d 912 (Del Ch. 1999).

⁹ Id. at 220. ¹² Levy at 222 (quoting *Chamison* at 925-26).

¹³ Sodano at *51-52.

¹⁴ Id. at *6.

¹⁵ Id. at *54.

Recent Litigation Affecting Private Funds

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of the LLC Agreement, and thus, the individual approval right as set forth in the LLC Agreement was implicated. This case has ramifications specifically where an extension of a dissolution date is being sought, and more generally, as to what constitutes an adverse effect for purposes of Delaware limited liability company law, as well as Delaware limited partnership law.

PROXY VOTING RULES

In the Matter of INTECH Investment Management LLC and David E. Hurley.

On May 8, 2008, in a settled administrative proceeding, the SEC issued an order finding that INTECH Investment Management LLC, a registered investment adviser ("INTECH"), and its former chief operating officer, David E. Hurley, had violated the SEC's proxy voting rule for registered investment advisers by not sufficiently describing its proxy voting policies and procedures to its clients and by failing to address a material potential conflict of interest. The proxy voting rule requires registered investment advisers to adopt proxy voting policies and describe them to clients, including procedures to address material conflicts of interest that may arise between the adviser and its clients. The rule is designed to ensure that advisers vote proxies in their clients' best interests and provide clients with information about how their proxies are voted. To satisfy its duty of loyalty, an adviser must cast the proxy votes in a manner consistent with the best interests of its client and must not subrogate a client's interest to its own. According to the proxy rule, an adviser may use a predetermined voting policy such as a third-party proxy voting service's platform to vote proxies, provided that the predetermined policy is designed to further the interests of clients rather than the adviser. According to the order, INTECH managed institutional portfolios for pension plans, foundations, unions, public funds and public corporations. As part of its investment advisory services, INTECH exercised voting authority with respect to many of its clients' securities. The order found that in deciding how to vote client securities, INTECH chose to rely upon the recommendations of a third-party proxy voting service called Institutional Shareholder Services ("ISS"). Specifically, INTECH chose an ISS platform known as the ISS-General Guidelines which typically recommended voting in accordance with corporations' management's recommendations ("ISS-General"). INTECH allegedly received inquiries and complaints from some of its union-affiliated clients about pro-management proxy votes that INTECH had cast on behalf of its clients as a result of following ISS-General. In response, INTECH switched to ISS Proxy Voting Service Guidelines that followed *(continued on page 11)*

Proposed Legislation Affecting Private Funds

■ Political Contributions by Certain Investment Advisers

On August 3, 2009, the SEC published proposed Rule 206(4)-5 under the Advisers Act that would prohibit an investment adviser from providing advisory services for compensation to a government client for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. The new rule would also prohibit an adviser from providing or agreeing to provide, directly or indirectly, payment to any third party for a solicitation of advisory business from any government entity on behalf of such adviser. Additionally, the new rule would prevent an adviser from soliciting from others, or coordinating, contributions to certain elected officials or candidates or payments to political parties where the adviser is providing or seeking government business. The SEC also is proposing rule amendments to Rules 204-2 and 206(4)-3 under the Advisers Act that would require a registered adviser to maintain certain records of the political contributions made by the adviser or certain of its executives or employees. The SEC is seeking public comment on the proposed rule and rule amendments; comments must be received by the SEC by October 6, 2009. Please see our August 11, 2009 client alert entitled *"SEC Proposes 'Pay to Play' Rule Regarding Political Contributions by Certain Investment Advisers"* for further information on this topic.

■ Private Fund Investment Advisers Registration Act of 2009

The U.S. Department of the Treasury, on behalf of President Barack Obama, recently introduced legislation entitled the "Private Fund Investment Advisers Registration Act of 2009," which would require all investment advisers to "private funds" (including hedge funds and private equity funds) with more than \$30 million of assets under management to register with the SEC. A "private fund" is defined as any investment company relying on the exceptions from registration provided by Section 3(c)(1) or Section 3(c)(7) of the U.S. Investment Company Act of 1940, as amended (the "Investment Company Act") that is either organized under the laws of the United States or that has 10% or more of its securities owned by

U.S. persons. Any such registered investment adviser would be required to submit to the SEC such reports regarding each private fund it advises as are "necessary or appropriate in the public interest and for the assessment of systemic risk" by the Board of Governors of the Federal Reserve System (the "Board") and the Financial Services Oversight Council (the "Council"), including the amount of assets under management, use of leverage (including off-balance sheet leverage), counterparty credit risk exposures, trading and investment positions, and trading practices. Such reports may also include "such other information" as the SEC, in consultation with the Board determines "necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." The records of each private fund advised by the investment adviser - which would be "deemed to be the records and reports of the investment adviser" - would be subject at any time to periodic, "special" and other examinations by the SEC. The SEC would make available to the Board and the Council copies of all reports and documents filed with the SEC as the Board or the Council may consider necessary to assess the systemic risk of a private fund and determine whether a private fund should be designated a "Tier 1 Financial Holding Company." A fund designated a Tier 1 Financial Holding Company would be subject to the Board's jurisdiction and subject to the prudential standards for such holding companies, which include strict capital, liquidity and risk management standards. All such reports obtained by the Board or the Council from the SEC would be kept confidential; however, the proposed legislation also provides that the SEC would not be authorized to withhold such information from Congress or any other federal department or agency. In addition to providing reports to the SEC, a registered adviser would be required to provide such reports, records and other documents to investors, prospective investors, counterparties and creditors of any private fund advised by such registered adviser as the SEC "may prescribe as necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk." The proposed Act would also eliminate the current "private adviser" exemption from registra-

Recent Litigation Affecting Private Funds

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AFL-CIO proxy voting recommendations ("ISS-PVS Guidelines") for all of its clients' securities. In addition, the order found that INTECH chose to follow the ISS-PVS Guidelines at a time when INTECH was participating in the annual AFL-CIO Key Votes Survey that ranked investment advisers based on their adherence to the AFL-CIO recommendations on certain votes. According to the order, INTECH believed that following the ISS-PVS Guidelines would improve its ranking in the survey and that the improved score would likely be helpful in maintaining existing union-affiliated clients and attracting new union-affiliated clients. The order found that when INTECH advised its clients about its proxy voting policies and procedures, it told clients that because it relied on a third-party proxy voting service, it did not "expect that any conflicts would arise in the proxy voting process." In addition, the order found that INTECH's written policies and procedures did not address the potential conflict caused by INTECH choosing the ISS-PVS Guidelines for all of its clients, while having an interest in retaining and obtaining union-affiliated clients. Moreover, although INTECH disclosed that it intended to rely on the ISS-PVS Guidelines to vote clients' securities, it did not, however, disclose that the ISS-PVS Guidelines followed AFL-CIO proxy voting recommendations. Without admitting or denying the findings, INTECH agreed to pay a penalty of \$300,000, and Mr. Hurley agreed to pay a \$50,000 penalty. The SEC's order found that INTECH willfully violated, and Mr. Hurley willfully aided and abetted and caused violations of, Section 206(4) of the Advisers Act, and Rules 206(4)-6(a) and (c) thereunder. This is the first enforcement action taken by the SEC for a proxy voting rule violation. ■

tion available to advisers with fewer than 15 clients in the preceding 12 months, and, in lieu thereof, would provide for a "foreign private adviser" exemption that would be available to an adviser that (i) has no place of business in the United States; (ii) during the preceding 12 months has had (a) fewer than 15 clients in the United States and (b) assets under management attributable to clients in the United States of less than \$25 million; and (iii) neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an adviser to any investment company registered under the Investment Company Act. Please see our July 20, 2009 client alert entitled *"Obama Administration Proposes Legislation Requiring Registration of All Private Fund Advisers"* for further information on this topic.

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Proposed Legislation Affecting Private Funds *(continued from page 11)*

■ Investor Protection Act of 2009

The U.S. Department of the Treasury, on behalf of President Obama, recently introduced legislation entitled the "Investor Protection Act of 2009." Specifically, the legislation proposes: (i) establishing consistent standards of conduct for broker-dealers and investment advisers (namely, to act solely in the interest of the customer or client); (ii) giving the SEC authority to prohibit mandatory arbitration clauses in broker-dealer, municipal securities dealer and investment advisory agreements; (iii) giving the SEC authority to regulate the quality and timing of disclosure documents and prospectuses with respect to registered investment companies; (iv) clarifying the SEC's authority to conduct consumer testing and encourage it to do so, in order to create more effective and clearer disclosures and to better assess its rules and programs; (v) expanding the SEC's whistleblower program by establishing a fund to pay whistleblowers for information that leads to enforcement actions resulting in significant financial awards; (vi) harmonizing liability standards so that the SEC can pursue those who aid and abet securities fraud; (vii) requiring accountability of securities professionals throughout the financial services industry; and (viii) establishing a permanent SEC Investor Advisory Committee. Please see our July 14, 2009 client alert entitled "*Obama Administration Releases Proposed Legislation to Strengthen the SEC's Authority to Protect Investors*" for further information on this topic.

■ Private Fund Transparency Act of 2009

Senator Jack Reed has introduced legislation entitled the "Private Fund Transparency Act of 2009" which eliminates the "private adviser exemption" under Section 203(b)(3) of the Advisers Act. The bill would (i) require all private fund advisers that manage more than \$30 million in assets to register as investment advisers with the SEC; (ii) provide the SEC with the authority to collect information from private funds, including the risks they may pose to the financial system; (iii) authorize the SEC to require private funds to maintain and share with other federal agencies any information necessary for the calculation of systemic risk; and (iv) clarify other aspects of SEC's authority in order to strengthen its ability to oversee registered investment advisers.

■ Amendments to Rule 206(4)-2 Under the Advisers Act

The SEC recently published proposed amendments to the rules governing the custody of client funds and securities by registered investment advisers. The proposed amendments enhance and expand on existing requirements for registered investment advisers under Rule 206(4)-2 (Custody of Funds or Securities of Clients by Investment Advisers) of the Advisers Act, which requires advisers who have custody of client assets to implement controls to protect such assets from being lost, misused, misappropriated or subject to the adviser's financial problems (such as insolvency). One proposed amendment would require all registered investment advisers that have custody of client funds or securities to undergo an annual surprise examination by an independent public accountant to verify that those client assets exist. (Particularly important to pooled investment vehicles, the proposed amendments would eliminate the exemption from the surprise examination requirement for a pooled investment vehicle that is audited at least annually and distributes audited financial statements to investors within 120 days of the end of its fiscal year.) Another proposed amendment would apply to advisers whose client assets are held or controlled by the adviser or a related person acting as a qualified custodian and would require such advisers to obtain a written "SAS-70" report from an independent public accountant registered with and inspected by the PCAOB that, among other things, describes the controls in place, tests the operating effectiveness of those controls and provides the results of those tests, and includes an opinion regarding the custodian's controls relating to custody of client assets. The proposed amendments also would include reporting requirements designed to alert the SEC staff and investors to potential problems at an adviser, and provide the SEC with important information for risk assessment purposes. An adviser would be required to disclose in public filings with the SEC, among other things, the identity of the independent public accountant that performs its surprise examination and amend its filings to report if it changes accountants. The accountant would have to report the termination of its engagement with the adviser and, if applicable, any problems with the examination that led to the termination of its engagement. If the accountants find any material discrepancies during the surprise examination, they would have to report them to the SEC. Under the proposed amendments, an adviser would be deemed to have

custody of any client assets that are directly or indirectly held by a related person in connection with advisory services provided by the adviser to its clients. The proposed amendments would also include several changes to Form ADV that would make certain currently permitted disclosures mandatory and would require additional details relating to topics already covered in the Form ADV.

■ Corporate and Financial Institution Compensation Fairness Act of 2009

The U.S. House of Representatives recently approved the "Corporate and Financial Institution Compensation Fairness Act of 2009." Although much of the bill applies only to public companies and deals with giving shareholders a "say on pay" for top executives, the bill would also require certain investment advisers to disclose incentive based compensation structures. Specifically, the bill requires "covered financial institutions," which includes investment advisers whether they are registered with the SEC or not, with "assets" of at least \$1 billion to disclose to the appropriate federal regulator (i.e., the SEC) the "structures of all incentive-based compensation arrangements offered by such covered financial institutions sufficient to determine whether the compensation structure: (a) is aligned with sound risk management; (b) is structured to account for the time horizon of risks; and (c) meets such other criteria as the appropriate federal regulators jointly may determine to be appropriate to reduce unreasonable incentives offered by such institutions for employees to take undue risks that (i) could threaten the safety and soundness of covered financial institutions or (ii) could have serious adverse effects on economic conditions or financial stability." The bill would give federal regulators the power to prescribe regulations that prohibit any incentive-based payment arrangements, or any feature of any such arrangement, that regulators determine encourages inappropriate risk by covered financial institutions.

■ European Commission's Draft Directive on Alternative Investment Fund Managers

The European Commission recently released a Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers (the "Directive"). The Directive aims to create a comprehensive and effective regulatory and *(continued on page 13)*

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supervisory framework for managers of hedge funds and private equity funds in the European Union. The Directive applies to managers and administrators established in the EU who manage alternative investment funds that are not regulated under the UCITS Directive, including hedge funds, private equity funds, commodity funds, real estate funds, infrastructure funds and other types of institutional funds (such managers, "AIF Managers" and such funds, "AIFs"). The Directive would only apply to:

- Leveraged AIF Managers - AIF Managers with assets under management (including any assets acquired through the use of leverage) equal to or greater than €100 million; and
- Non-Leveraged AIF Managers - AIF Managers with assets under management equal to or greater than €500 million, where the portfolio of AIFs consists of AIFs that are not leveraged and have no redemption rights exercisable during a period of five years following the date of constitution of each AIF.

To operate in the EU, regulated AIF Managers would be required to obtain authorization from the competent authority of their home Member State and would be subject to ongoing requirements. Among other requirements, these AIF Managers would be required to demonstrate that they are suitably qualified to provide AIF management services and would be required to provide detailed information on their planned activities, the identity and characteristics of the AIFs managed, the governance of the AIF Managers (including any delegation arrangements), internal arrangements with respect to risk management, arrangements for the valuation and safe-keeping of assets and the systems of regulatory reporting. Regulated AIF Managers would be required to report on a regular basis to their home Member State's competent authority on the principal markets and instruments in which they trade, their principal exposures, performance data and concentrations of risk. These AIF Managers would also be required to notify the competent authority of the identity of the AIFs managed, the markets and assets in which the AIFs invest, and the organizational and risk management arrangements established in relation to the AIFs. The Directive also contains a number of common disclosure requirements that would be applicable to all regulated AIF Managers, such as risk, return and liquidity characteristics, identity of service providers, risk management systems, percentage of an AIF's

assets that are subject to special arrangements (e.g., side pockets), fees and charges that are directly or indirectly borne by investors and preferential treatment provided to other investors by the AIF Managers. Regulated AIF Managers would be required to hold and retain a minimum level of capital of at least €125,000, plus 0.02% of the amount by which the value of an AIF Manager's portfolios exceeds €250 million. An AIF Manager authorized in its home Member State would be entitled to provide management services and/or market AIFs to "professional investors" in any country within the EU (subject to a notification procedure under which relevant information is provided to the home and host Member State). AIF Managers would be permitted to continue marketing to retail investors in those Member States that allow such marketing, and those Member States may impose additional regulatory requirements on the AIF Managers or the AIFs. However, marketing to retail investors would only be permitted where a Member State expressly grants that right and such right may not be "passport" to any other Member State. The Directive also contemplates "passporting rules" applicable to AIF Managers established in a third country who offer interests in an AIF to professional investors in the EU; however, due to the complexity of creating such a system, passporting rules would only come into force three years after the Directive becomes effective. The Directive now passes to the European Parliament and then the European Council for further debate and consideration. Following adoption, the Directive would be complemented by implementing measures adopted by the European Commission and would then need to be transposed into national law by the Member States. Member States would have flexibility in incorporating the Directive into national law. The Directive is not expected to come into force until 2011. Please see our May 5, 2009 client alert entitled "*European Commission Publishes Draft Directive on Alternative Investment Fund Managers*" for further information on this topic.

■ Levin Bill to Tax Carried Interest as Ordinary Income

Representative Sander Levin has reintroduced legislation to tax carried interest capital gains at ordinary income rates. This bill is substantially similar to a version proposed by Representative Levin in June 2007, although it goes further than the prior proposals in some important respects; the Obama Administration 2010 budget proposes similar legislation. As with the prior proposals, this bill

would tax any income from an "investment services partnership interest" at ordinary rather than capital gains rates. It would also tax gains from the dispositions of such interests at ordinary rates. Going beyond earlier proposals, gains realized in transactions that would otherwise be tax-deferred (including, it appears, gifts) are also subject to tax at ordinary rates. As written, the bill would cover both carried interests and so-called "fee waiver" or "MPI" interests. "Investment services partnership interests" are interests in a partnership held by a person if it was reasonably expected at the time the person acquired the interest that the person or a related party would provide a substantial quantity of advisory or management services, directly or indirectly, to the partnership with respect to "specified assets." Specified assets generally consist of securities, rental and investment real estate, partnership interests, and commodities, as well as options and derivatives with respect to those assets. Income and gain from a "disqualified interest" is also treated as ordinary income. A disqualified interest is, in general, an interest in an entity the value of which is substantially related to the amount of income or gain generated by assets with respect to which investment management services are performed. Exceptions are provided for, among other things, interests in a taxable C corporation. Thus "founders stock" and similar interests would appear not to be covered. However, an interest in a non-U.S. corporation the income of which is not effectively connected with a U.S. trade or business or subject to a comprehensive income tax is a disqualified interest. The effect of this provision appears to be to shut down a PFIC-based structure that has been discussed in the press to substitute for partnership carried interests in offshore corporations not themselves subject to tax. As with the earlier versions of the legislation, there is an exception from ordinary income treatment for reasonable returns on "qualified capital interests." Under this rule, the service-provider partner would receive capital gains treatment on returns on capital to the extent of the similar returns received by non-service provider, unrelated limited partners. In addition, the rule characterizing gains from dispositions of investment service partnership interests as ordinary income would not apply to any portion of the gain attributable to a qualified capital interest. The proposal defines a qualified capital interest as the portion of a partner's interest in the capital of a partnership attributable to the amount of money or the fair market value of property contributed to the partnership in *(continued on page 14)*

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exchange for the interest. Expanding on the prior proposals, (i) any amounts the partner included in gross income with respect to the transfer of the interest and (ii) cumulative net income and gain taken into account with respect to the interest for years to which the new law applies would also be treated as capital investments, but such amounts would be reduced by losses and distributions. A qualified capital interest does not include a capital interest acquired with the proceeds of a loan from or guaranteed by the partnership or a partner, thus cutting off another "work around" discussed in

the press. As with the prior carried interest proposals, this bill would clearly apply to managers of traditional buyout funds, real estate funds, and hedge funds that rely on carried interest allocation. Profits interests issued to employees in other kinds of businesses may not be caught by this legislation (largely because of the limiting definition of "specified assets"). Please see our April 6, 2009 client alert entitled "*Levin Reintroduces Bill That Would Tax Carried Interest as Ordinary Income*" for further information on this topic. ■

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