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# Investment Management News

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INSIDE:



**Investment Management Group**

The Paul, Weiss Investment Management Group focuses on the organization, fund raising and maintenance of private investment funds of every type, including buyout funds, hedge funds, venture capital funds, hybrid funds, distressed funds, mezzanine funds, sponsorship funds, infrastructure funds, co-investment funds and funds of funds. The group is also involved in acquiring, merging and advising investment management businesses. In addition, the group represents a diverse group of domestic and foreign investors in connection with their investments in private investment funds.

## Delaware LLLPs: A Viable Option for Private Investment Funds?

MARCO V. MASOTTI, LOUIS G. HERING,[1] MICHAEL S. HONG AND ADAM B. HAHN

### Introduction

Historically, private investment funds (such as onshore hedge funds and private equity funds) have relied on the limited partnership as the primary organizational form of choice, despite the existence of a number of different organizational forms through which a private investment fund could, in theory, conduct its activities. The limited liability company, for example, exhibits characteristics that make it both similar to and more attractive than the limited partnership. A limited liability company can be structured to mimic the centralized management of a limited partnership, yet it can also protect all of its members (including its managing member) from personal liability for the obligations of the company solely by virtue of being members. Given that in the limited partnership context the general partner (i.e., the fund sponsor or manager) faces unlimited liability for the debts and obligations of the partnership, the additional liability shield provided by a limited liability company solves the unlimited liability problem and, thus, alleviates the need for a fund sponsor to establish a separate limited liability entity to serve as a general partner in order to gain liability protection.

Despite the potential benefits of the limited liability company form, private investment funds have continued to opt for the limited partnership for two reasons. First, unlike the limited liability company, the fundamental nature of a limited partnership as a "partnership" means that it is more likely to be afforded pass-through tax treatment with respect to its equity holders in a variety of foreign (non-U.S.) jurisdictions. Second, and perhaps more importantly, the limited partnership is a relatively well-established business form and is one with which fund sponsors, investors and courts alike have become well accustomed.[2] Accordingly, there are significant marketing advantages associated with fund raising through an organizational form that prospective investors are more likely to understand and therefore accept as the entity in which to invest their capital.

Recent trends in the market for private investment fund formation, however, warrant another look into whether the limited partnership is, indeed, the optimal organizational form. The advent and development of the modern limited partner advisory committee, as well as the increased public and regulatory scrutiny of fund sponsors, make the search for an organizational form with more of the benefits of both the limited partnership and the limited liability company all the more relevant today than it was perhaps a few years ago. One particular form that is likely to achieve this is the Delaware limited liability limited partnership (the "LLLP"). The LLLP is essentially a limited partnership, but offers limited liability protection for its general partners similar to the limitation on liability offered to managing members of a limited liability company. In addition, *(continued on page 2)*

[1] Mr. Hering is a partner with Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Delaware.

[2] There is a relative lack of jurisprudence on the liability of members of a limited liability company, for example, when compared to the extensive case law examining the liability of limited partners of a limited partnership.

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the conversion of an existing limited partnership into an LLLP is a relatively straightforward procedure. This article offers a simple introduction to the LLLP and explores its relative advantages and disadvantages in comparison to other business organizational forms.

## LLLP Defined – A Different Liability Shield

As its name suggests, the limited liability limited partnership is a special form of limited partnership in much the same way that a limited liability partnership is a special form of general partnership. In fact, neither the Delaware limited liability partnership nor the LLLP can be found in independent statutory regimes, but rather, both are based on supplements to existing statutes (the Delaware Revised Uniform Partnership Act, in the case of the limited liability partnership, and the Delaware Revised Uniform Limited Partnership Act (the "DRULPA"), in the case of the LLLP). As such, the fundamental characteristics of limited liability partnerships and LLLPs (such as governance) are consistent with their underlying general partnership and limited partnership organizational forms, respectively.

Unlike a limited partnership, however, under §17-214(c) of the DRULPA there is no unlimited liability exposure for a general partner of an LLLP. Importantly, this additional liability shield prevents each general partner of the LLLP from being personally liable, on an unlimited liability basis, for the debts and obligations of the LLLP. This shield also provides an extra layer of liability protection for the limited partners. That is, in addition to having their personal liability limited to the amount of their capital investments while remaining passive limited partners, the additional liability shield provided by the LLLP would also extend to limited partners who have participated in the control of the business of the partnership and who may have exposed themselves to unlimited liability as general partners.

Although Delaware limited partnership law enumerates a number of management activities in which limited partners can be engaged without being considered as participating in the control of the business (such as advising the general partner with respect to matters of the limited partnership's business or making determinations in connection with investments), the prospect of this additional liability protection for limited partners means that the governance structure of the LLLP can be substantively, if not significantly, different from that of a limited partnership. Advisory board members once reluctant to render binding determinations may be willing to (or may in fact desire to) assume greater oversight responsibilities in exchange for adopting an organizational form that limits the liability of the general partner.

## "Formation"

In order to become an LLLP, a limited partnership must satisfy the four requirements of §17-214 of the DRULPA. First, the limited partnership's partnership agreement must permit it to become an LLLP, or if such a transformation is not expressly permitted, it must be approved by all of the general partners and by a majority-in-interest of the limited partners (or each class of limited partners if more than one class exists). Second, the limited partnership must file a Statement of Qualification containing: (i) the name of the partnership; (ii) the address of its registered office; (iii) the name and address of its registered agent for service of process; (iv) the number of partners at the time the statement is effective; (v) a statement that the partnership elects to be a limited liability limited partnership; and (vi) the date or time upon which the statement is to be effective (if it is not to be effective upon filing). Third, the limited partnership must pay certain filing fees.[3] Fourth, the limited partnership must include as the last words or letters in its name "Limited Liability Limited Partnership," "L.L.L.P." or "LLLP." The limited partnership's status as an LLLP and the protection provided by the additional liability shield are effective upon the filing of the Statement of Qualification (or future effective date, if one is specified).

In order to retain its status as an LLLP, by June 1 of each calendar year following the year in which a limited partnership becomes an LLLP, the LLLP must file an Annual Report (setting out its name, the number of partners, the address of its registered office and the name and address of its registered agent for service of process) and remit the applicable fee. Failure to file the Annual Report or pay the required filing fee authorizes the Secretary of State of the State of Delaware to revoke the limited partnership's status as an LLLP.[4]

## Further Comparisons to Similar Forms

The DRULPA provides that, with the exception of LLLP-specific registration and liability shield provisions, LLLPs are governed by the same statutory provisions that apply to limited partnerships. As such, there are a few significant differences between limited partnerships and limited liability limited partnerships, apart from those referenced above, as a matter of Delaware law. From that perspective, LLLPs are (or, at least, should be) more familiar to lawyers and business people in the private investment funds world than at first glance. Similarly, the registration of a limited partnership as an LLLP has no impact on the membership requirements or governance of the partnership in question.

Furthermore, both limited partnerships and LLLPs require at least two partners (one general partner and one limited partner). The general partner is responsible for managing the business of the partnership (and is the only partner authorized to bind the partnership), while the limited partner largely does not participate in the management or business of the partnership (in order to avoid the risk of assuming the liability of a general partner). This limitation is moot as a practical matter upon registration as an LLLP, however, as the additional liability shield protection ensures that even if a limited partner participates in the management or business of the partnership, that partner would not face unlimited liability for the obligations of the partnership.

General partnerships and limited liability partnerships, of course, also require at least two partners (although all partners are general partners). Under these forms of partnerships, each partner is an agent of the partnership and any act engaged in by one partner that appears to advance the interests of the partnership can bind the partnership. Each of the foregoing forms can be distinguished easily from the limited liability company, which only requires a single member. The limited liability company can be managed either by an appointed manager (or management team) or by the members themselves, and all members and managers, individually, have the ability to bind the company, unless the company's operating agreement specifies otherwise.

With respect to U.S. tax treatment, general partnerships, limited partnerships, *(continued on page 3)*

[3] There can be a significant difference in the annual filing fees charged to limited liability partnerships and LLLPs in comparison to other organizational forms. While general partnerships, limited partnerships and limited liability companies are subject to annual filing fees of $200 regardless of the number of partners or members, limited liability partnerships and LLLPs are required to pay fees of $200 per general partner per year (up to a maximum of $120,000 per year).

[4] A limited partnership whose status as an LLLP has been revoked may apply to the Secretary of State of the State of Delaware for reinstatement of that status by, among other things, stating in its application that grounds for revocation did not exist or have been corrected.

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limited liability partnerships and LLLPs are all subject to tax treatment as partnerships (i.e., neither the registration of a general partnership as a limited liability partnership nor the registration of a limited partnership as an LLLP will change the tax rules applicable to the underlying partnership). As such, income generated by each of these partnerships is generally not subject to entity-level tax and the character of such income (which is determined at the entity level) passes through to the individual partners to be included in their personal tax returns. The default U.S. tax treatment for limited liability companies with two or more members is the same as that applied to partnerships. It must be noted, however, that each of these organizational forms has the ability to elect to be treated as a separate corporate entity (and thus subject itself to entity-level tax).

## The Pros and Cons of LLLPs for Private Investment Funds

Although there is no legal restriction under Delaware law on the potential use of the LLLP form by a private investment fund (other than the restriction on its use for the business of banking), there are a number of advantages and disadvantages that should be considered before an established or prospective private investment fund chooses to register as or become an LLLP. Three advantages are as follows. First, at its core, the LLLP is essentially still a limited partnership. Thus, the limited partnership agreement that lies at the heart of most private investment funds will retain the "look and feel" of the vast majority of its operative provisions, with the exception perhaps of its exculpatory and indemnification provisions which might run to both the general partner and any limited partner that fulfills a "management" role. Moreover, by filing the election to become an LLLP, the partners can obtain the benefits of the additional liability protection while still retaining the business form with which they are familiar (rather than having to convert to another form, such as a limited liability company or limited liability partnership). In addition, even if the election filings for LLLP status are made improperly or are subject to other complications that result in the status being revoked, the investors would still be protected from unlimited liability as they would retain the traditional liability shield attributable to limited partners of a limited partnership.

Second, as the additional liability shield builds upon the established limited partnership framework, the certainty for investors with respect to their traditional liability protection as limited partners is unlikely to change. While there may be uncertainty surrounding the scope of the additional liability protection in an LLLP due to the minimal case law on the subject to date, registration as an LLLP (although involving a higher fee) poses no downside liability risk and only the potential of additional protection in comparison to the traditional limited partnership form.

Third, by obtaining limited liability protection for the general partner through registration as an LLLP, sponsors, when forming new funds, would no longer necessarily have to incur the cost, time and effort involved with establishing and maintaining a separate limited liability entity to serve as the general partner in order to achieve this protection.

Despite these advantages, there are two primary disadvantages associated with the LLLP form. First, the liability shield of an LLLP may encounter difficulties as the partnership engages in activities in states outside of the State of Delaware. While all states have adopted foreign recognition laws enabling foreign limited liability partnerships to register, engage in business (in some instances, in certain professions only)[5] and apply the laws of state registration for the purposes of determining partner liability, similar recognition laws have not been adopted throughout the United States with respect to LLLPs. As a result, there is uncertainty about the treatment that a Delaware LLLP would face in states other than Delaware or the ability of a Delaware LLLP to qualify to do business in such states. Other states, such as the State of New York, appear to specifically deny foreign limited partnerships – and Delaware LLLPs qualify as foreign limited partnerships – the benefits of the additional liability shield. Under such circumstances, a Delaware LLLP would only be afforded the status of a foreign limited partnership (or could only seek to qualify to do business as a foreign limited partnership), thus eliminating the benefits of the additional liability shield for both general and limited partners.[6]

Second, the presence of an additional liability shield may be disruptive to the traditional balance of liability exposure that delineates the role of the general partner (i.e., management) relative to the role of the limited partner (i.e., capital). On the one hand, the presence of the additional shield could increase the extent to which major limited partner investors desire to intervene (or have the right to intervene) in the management of the fund. In a traditional limited partnership, the potential cost to an investor of intervention (i.e., the risk of losing limited liability protection) may have outweighed the potential benefits. With the additional liability protection for limited partners, however, these costs, and thus the disincentive to intervene, may be mitigated.

On the other hand, granting such enhanced management rights could give rise to inter-investor conflicts, pitting major limited partners who may desire such rights against other limited partners who may have little to no desire to see fellow investors taking on a management role. One would also expect major limited partners to resist assuming unwanted fiduciary obligations relative to their fellow investors – a factor that itself might mitigate the desire to obtain those enhanced rights in the first place (unless the fund sponsor and other investors are willing to limit contractually those obligations). The dynamics of such conflicts are likely to play out differently depending on the relative bargaining power of each fund constituency.

## Conclusion

The foregoing discussion of the LLLP form, its key differences from other forms of business entities and its applicability to private investment funds, attempts to provide readers with an introduction to LLLPs and the significant issues surrounding their use. This discussion is not, however, intended to be exhaustive. Factors and considerations unique to each private investment fund (or any other business) will be important to the decision-making process that results in the selection of the appropriate form of legal entity. Given the potential benefits, however, existing and prospective private investment funds are encouraged to strongly consider the possibility of this form of entity as an alternative to the traditional limited partnership. ■

[5] The State of California, for instance, recognizes foreign limited liability partnerships for registration purposes only to the extent they or their partners (or related partnerships) are engaged in certain professional activities (such as architecture, public accountancy or the practice of law). The State of New York also requires that foreign limited liability partnerships applying for foreign qualification also state their profession, although the State does not specifically enumerate what professions apply. As of today, foreign LLLPs may use (or at least have used) the application for authority form intended for foreign limited liability companies, which does not require a statement of profession, in order to seek foreign qualification in the State of New York.

[6] Adoption of the LLLP form, however, still offers the prospective benefit of an additional liability shield in states where it is less clear whether or not they would be recognized. One might also expect the prospective loss of the shield to provide a mutual disciplining effect on general partners and limited partners alike, providing a disincentive against risky conduct that could amplify their liability exposure if the shield were ever disregarded.

# Registration and Reporting Implications of the Private Fund Investment Advisers Registration Act

KAREN J. HUGHES, STEPHANIE R. MCCAVITT AND GITANJALI WORKMAN

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law. Set forth in Title IV of the Dodd-Frank Act is the Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act"). The purpose of the Registration Act is to close a "regulatory gap" and create a more cohesive and robust regulatory regime that will address the perceived lack of effective monitoring and examination of investment advisers to hedge funds and certain other private funds. Broadly speaking, the Registration Act: (i) eliminates the "private adviser exemption" from the Investment Advisers Act of 1940 (the "Advisers Act"), thereby requiring many investment advisers that were previously exempt from registration to register with the Securities and Exchange Commission (the "SEC"); (ii) requires certain smaller investment advisers that were previously eligible to register with the SEC to transition to state registration; and (iii) imposes additional recordkeeping and reporting obligations on registered, as well as certain non-registered, investment advisers that advise "private funds" (as defined below). While investment advisers that are no longer exempt from SEC registration will be required to make significant changes in order to comply with the new regime, the Registration Act will also have an impact on many investment advisers that are exempt from SEC registration. The Registration Act becomes effective on July 21, 2011. During this one-year period, the SEC is expected to adopt rules and regulations providing procedures for registration and reporting and clarifications with respect to certain ambiguous provisions of the Registration Act.

## Do I Need to Register with the SEC?

The Registration Act eliminates both (i) the "private adviser exemption" from SEC registration previously contained in Section 203(b)(3) of the Advisers Act for investment advisers that do not hold themselves out to the public as investment advisers and have fewer than 15 clients; and (ii) the "intrastate exemption" from SEC registration (applicable to investment advisers with clients that are all residents of the state in which the adviser maintains its principal place of business) where the investment adviser advises any private fund. As a result of the foregoing, many investment advisers to private funds will be required to register with the SEC, unless they fall within one of the specified exemptions.

**Certain Private Fund Advisers.** The Registration Act provides that an investment adviser that solely advises private funds and has aggregate assets under management ("AUM") in the United States of less than $150 million is exempt from registration with the SEC. A "private fund" is defined as any issuer that would be an investment company under Section 3 of the Investment Company Act of 1940 (the "Investment Company Act"), but for the exception provided by either Section 3(c)(1) or Section 3(c)(7) thereunder. Most private investment funds[1] commonly rely on these provisions of the Investment Company Act to avoid regulation as an investment company and will therefore qualify as a "private fund." Note, however, that based upon a plain reading of this exemption, if an investment adviser advises private funds, but the adviser also advises separately managed accounts or other types of investment vehicles that do not fall within the definition of a private fund, such an adviser would not be eligible to rely on this exemption. In order for certain advisers to avail themselves of this exemption, there may be a trend in the future whereby separately managed accounts are structured as "private funds" rather than as managed accounts. In addition, no guidance is provided with respect to how "aggregate assets under management in the United States" for purposes of the $150 million threshold test will be determined. Will the SEC look to the principal place of business of the investment adviser, the jurisdiction in which the private fund is organized, the domicile of individual investors or the location of the portfolio investments of the private funds?[2] Importantly, investment advisers that avail themselves of this exemption will remain subject to such recordkeeping and reporting requirements as the SEC "determines necessary or appropriate in public interest or for the protection of investors."

**Venture Capital Fund Advisers.** An investment adviser will also qualify for an exemption from SEC registration if it acts as an investment adviser solely to one or more venture capital funds. Within the next year, the SEC must define the term "venture capital fund." A Senate report on the Registration Act released earlier this year described venture capital funds as a subset of private investment funds specializing in long-term equity investments in small or start-up businesses. This has been the only attempt thus far to define venture capital funds and implies that the definition will focus on the types of investments that these funds make. In any event, one would expect that the definition will be narrowly construed so as not to capture private equity funds. Also note that similar to the reporting requirements described above, such advisers will be required to maintain records and provide to the SEC reports that the SEC "determines necessary or appropriate in public interest or for the protection of investors."

**Foreign Private Advisers.** The Registration Act provides a limited exemption for a "foreign private adviser," which is defined as an investment adviser that: (i) has no place of business in the United States; (ii) has, in total, fewer than 15 clients and investors in the United States in private funds advised by the investment adviser; *(continued on page 5)*

[1] Note that certain types of real estate funds rely on the exception provided in Section 3(c)(5) of the Investment Company Act, and, as a result, will not fall within the definition of a "private fund" for purposes of the Registration Act. Although an investment adviser that advises such real estate funds may have to register under the Registration Act (because it may not fall within one of the enumerated exemptions from registration), it appears that such an adviser would not be subject to the heightened recordkeeping and reporting requirements applicable to "private funds" with respect to any fund relying on Section 3(c)(5) of the Investment Company Act.

[2] By comparison, the Registration Act provides that in calculating AUM for purposes of the "foreign private adviser" exemption (discussed below), the aggregate AUM "attributable to clients in the United States and investors in the United States in private funds" must be taken into account.

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(iii) has aggregate AUM attributable to clients and investors in the United States in private funds advised by such adviser of less than $25 million (or such higher amount as the SEC may, by rule, determine); and (iv) neither holds itself out generally to the public in the United States as an investment adviser nor acts as an investment adviser to any investment company registered under the Investment Company Act or any business development company.

**Family Offices.** The Registration Act excludes from the definition of "investment adviser" contained in Section 202(a)(11) of the Advisers Act investment advisers that advise only "family offices," consequently exempting such advisers from SEC registration. The Registration Act requires the SEC to define the term "family office" for purposes of this exclusion, and the SEC must do so in a manner that: (i) is consistent with its existing exemptive orders on family offices and the grandfathering provisions set forth in clause (iii) below; (ii) recognizes the range of organizational, management and employment structures employed by family offices; and (iii) does not exclude certain "grandfathered" investment advisers (i.e., persons that were not registered or required to be registered under the Advisers Act on January 1, 2010, solely because such persons provide investment advice to, and were engaged, prior to January 1, 2010, in providing investment advice to, certain natural persons and entities associated with a family office). Notwithstanding the foregoing, family offices excluded from the definition of the term "investment adviser" by virtue of this grandfathering provision will nevertheless be deemed investment advisers for purposes of certain antifraud provisions of the Advisers Act, specifically, Sections 206(1), (2) and (4) thereunder.

**CFTC Registered Advisers that Advise Private Funds.** The Registration Act provides a conditional exemption from registration for investment advisers registered with the Commodity Futures Trading Commission as commodity trading advisers that advise private funds. If the "business of the advisor should become predominately the provision of securities-related advice," however, then such adviser must register with the SEC. There is currently no guidance as to how this standard will be measured.

**Small Business Investment Company Advisers.** An investment adviser that solely advises small business investment companies, which are regulated by the Small Business Administration, is also exempt from SEC registration.

**Mid-Sized Private Fund Advisers.** With respect to "mid-sized private funds," the Registration Act requires the SEC to provide registration and examination procedures that reflect the level of systemic risk posed by such funds taking into account the size, governance and investment strategy of such funds. For these purposes, the Registration Act does not define "mid-sized funds;" however, in the provisions of the Registration Act delineating the AUM thresholds for state and federal regulation of investment advisers (discussed below), mid-sized investment advisers are characterized as those with AUM between $25 million and $100 million. It is unclear whether the same standard will be applied here.

## Do I Need to Register with State Securities Regulators?

The Registration Act prohibits an investment adviser from registering with the SEC if the adviser: (i) has AUM between $25 million and $100 million (or such higher amount as the SEC may, by rule, determine); and (ii) is required to be registered as an investment adviser with the securities regulator of the state in which it maintains its principal office and place of business and, if registered, would be subject to examination as an investment adviser by such state regulator (unless the investment adviser is an adviser to a registered investment company or business development company). If any investment adviser would be required to register with 15 or more states, it may instead register with the SEC. As a result, some investment advisers that are currently registered with the SEC must de-register with the SEC and, instead, register with their home state(s). This change will allow the SEC to focus its time and resources on larger investment advisers. Importantly, advisers located in states that do not have registration and examination requirements are still subject to the SEC's current registration threshold, specifically, advisers with AUM of more than $30 million must generally register with the SEC, and advisers with AUM between $25 million and $30 million may elect to register with the SEC.

## What are my Recordkeeping and Reporting Obligations?

The Registration Act will subject certain registered investment advisers to enhanced recordkeeping, examination, reporting and disclosure requirements. In addition, the records of any private fund advised by an SEC-registered investment adviser are "deemed to be the records and reports of the investment adviser." SEC-registered investment advisers to private funds are required to maintain records regarding each private fund they advise, including a description of the following: amount of AUM; use of leverage; counterparty credit risk exposures; trading and investment positions; valuation policies and practices of the fund; types of assets held; side arrangements or side letters; trading practices; and other information relevant to determining potential systemic risk. There is currently no guidance as to what types of other information the SEC will deem relevant to determining potential systemic risk. SEC-registered investment advisers will also be subject to ongoing periodic reporting requirements which could be expanded beyond the current requirements under Form ADV.

Certain investment advisers not subject to registration with the SEC will also be subject to recordkeeping and reporting requirements. Specifically, investment advisers that solely advise (i) private funds and have AUM in the United States of less than $150 million; and (ii) venture capital funds are, in each case, required to maintain records and provide to the SEC reports that the SEC "determines necessary or appropriate in public interest or for the protection of investors." Although this broad standard creates uncertainty as to the extent of the recordkeeping and reporting requirements that will be promulgated by the SEC, practitioners expect that the SEC may adopt a "registration-lite" form applicable to this category of investment advisers.

The SEC will report annually to Congress on how the SEC uses the data collected to monitor the markets for the protection of investors and the integrity of the markets. The SEC will share with the Financial Stability Oversight Council *(continued on page 6)*

## Registration and Reporting Implications of the Private Fund Investment Advisers Registration Act *(continued from page 5)*

(the "Council") such reports and other documents provided to it by investment advisers as the Council considers necessary for the purposes of assessing the systemic risk of private funds. Confidentiality protection is provided for any proprietary information submitted to the government, including sensitive, non-public information regarding the investment adviser's investment or trading strategies, analytical or research methodologies, trading data, computer hardware or software containing intellectual property. Also note that Section 210(c) of the Advisers Act has been amended to permit the SEC to require an investment adviser to disclose the identity, investments or affairs of any client "for purposes of assessment of potential systemic risk."

As per the Registration Act, reports filed with the SEC[3] by investment advisers are not subject to disclosure pursuant to Freedom of Information Act ("FOIA") requests. In addition, pursuant to Section 9291 of the Dodd-Frank Act, the SEC "shall not be compelled to disclose records or information" if that information was obtained for "surveillance, risk assessments or other regulatory and oversight activities." Since the passage of the Dodd-Frank Act, a number of bills have been proposed to amend Section 9291 over concerns that the exemption is too broad, does not serve the public interest and is inconsistent with the goal of greater transparency for consumers and investors. House Financial Services Committee Chairman Barney Frank has scheduled a hearing for September 23, 2010, to examine whether the scope of the SEC's exemption from FOIA requests should be narrowed. In letters submitted to Chairman Frank and Senate Banking Committee Chairman Christopher Dodd, SEC Chairman Mary Schapiro stated, "The Dodd-Frank Act mandates a number of new responsibilities for the SEC to protect investors, including new authority over hedge funds, private equity funds and venture capital funds. . . . Fulfilling these responsibilities will require the SEC to expand and improve our examination and surveillance capabilities in order to provide the type of risk-focused regulatory oversight investors deserve. In order for our efforts to be successful, it is important that registered entities be able to provide us with access to confidential information without concern that the information will later be made public."

### What will SEC Registration entail?

Once registered with the SEC, investment advisers are subject to routine and surprise examinations by the SEC staff. SEC-registered investment advisers must also comply with various substantive requirements of the Advisers Act. Some of the key areas of responsibility include:

- **Compliance Policies and Procedures -** adopting and implementing a compliance program reasonably designed to prevent and detect any violation of the Advisers Act, including appointing a chief compliance officer and reviewing compliance policies on an annual basis;
- **Investment and Trading Practices -** complying with the anti-fraud rules under the Advisers Act and complying with substantive requirements of the Advisers Act, including rules relating to performance fees, custody arrangements, pay to play prohibitions, agency-cross transactions, principal transactions, etc.;
- **Record Retention -** maintaining and retaining corporate, accounting and performance records, client related correspondence and trade confirmations for at least five years;
- **Code of Ethics -** adopting standards of conduct covering the adviser's employees, including personal securities trading by such employees;
- **Rules on Advertising -** complying with the advertising restrictions and prohibitions contained in the Advisers Act;
- **Additional Disclosure Obligations -** disclosing financial or disciplinary actions; and
- **Filings -** filing, updating and amending Form ADV as required by the Advisers Act.

[3] Note, however, that under existing law, Part 1 of Form ADV will continue to be publicly available on the SEC's website. In addition, on July 21, 2010, the SEC adopted amended rules (see http://www.sec.gov/rules/final/2010/ia-3060.pdf) which will also make Part 2 of Form ADV publicly available on the SEC's website.

## SEC Announces Open Process for Regulatory Reform Rulemaking

On July 27, 2010, the Securities and Exchange Commission (the "SEC") announced that it is making it easier for the public to provide comments as the agency sets out to make rules required under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Under a new process, the public will be able to comment before the agency even proposes its regulatory reform rules and amendments. To facilitate public comment, the SEC is providing a series of e-mail links and mailboxes on its website. These mailboxes are organized by topic and are listed starting with rules that have the shortest time frame for implementation. The public can provide preliminary comments on topics including over-the-counter derivatives, hedge funds, corporate disclosure, credit rating agencies and other areas in which the SEC will be engaged in rulemaking and studies over the next 18 months. Submitted comments will also be posted on the SEC website for full transparency. In addition, the SEC staff will follow newly-established best practices when holding meetings with interested parties in order to ensure full transparency to the public.

To access the mailboxes, go to http://www.sec.gov/spotlight/regreformcomments.shtml

# How High Should Your High Water Mark Be?

JENNIFER A. SPIEGEL

In the wake of the recent financial crisis, many hedge funds are still struggling to climb back to their "high water marks"-the prior highest point of profitability, or the prior highest net asset value ("NAV"), of a hedge fund. Some hedge fund firms have lost talented investment professionals, traders and portfolio managers along the way, as the prospect of future profits and a share of the incentive allocation or carried interest becomes too remote for some to wait out the downturn. The following summarizes different approaches to the traditional high water mark mechanism, some motivated by the current economic climate, and provides an analysis of each approach.

## The Traditional High Water Mark

Assuming that a hedge fund is structured as a limited partnership, in the traditional high water mark regime, the general partner of the partnership is not entitled to an incentive allocation – typically a 20% share of net profits – until the fund has recovered prior losses and generated additional profits. Because investors are periodically subscribing for new interests and withdrawing existing interests, the high water mark is measured on an investor-by-investor basis.[1] The following example illustrates how the traditional high water mark mechanism works, in its simplest form.

Assume Investor X invests $1 million in Fund A on January 1, 2008. Further assume that, as of December 31, 2008, Investor X's capital account balance has declined in value to $700,000. Under these facts, Fund A's general partner is not entitled to any incentive allocation in respect of Investor X's investment until Investor X's capital account balance exceeds $1 million – the high water mark for Investor X's capital account as of December 31, 2008. If we further assume that Investor X's capital account balance increases to $1.2 million by December 31, 2009, Fund A's general partner then is entitled to 20% of the $200,000 that exceeds the $1 million high water mark. Therefore, as of January 1, 2010, the high water mark in respect of Investor X's capital account would now be $1.16 million (typically the new high water mark is measured net of the incentive allocation taken, $40,000 in this case, so that the fund does not have to earn back the amount deducted as incentive allocation).

*As the hedge fund market has matured and evolved over the last decade, so have the approaches to implementing the high water mark.*

## Variations on a Theme

As the hedge fund market has matured and evolved over the last decade, so have the approaches to implementing the high water mark. The following outlines some of these approaches.

**The Benchmark High Water Mark.** Under this approach, an independent benchmark-such as the performance of the S&P 500 Index-substitutes for the high water mark. Thus, the general partner is entitled to its incentive allocation in any given year only if the profits for that year in respect of an investor's capital account exceed that predetermined benchmark. This approach may be most appropriate where a fund's performance is strongly correlated with a particular market and a published index for such market exists. The following example illustrates how a benchmark high water mark might work.

Assume that Fund B invests primarily in U.S. municipal bonds. An appropriate benchmark might be the performance of the S&P Investortools Municipal Bond Index. Further, assume that Investor X invests $1 million in Fund B on January 1, 2008, and that, as of December 31, 2008, Investor X's capital account balance has declined in value to $700,000. Assuming that the weighted average value of the S&P Investortools Municipal Bond Index over 2008 was -40%, there are two possible ways to employ a benchmark high water mark mechanism based on that index.

On the one hand, Fund B's general partner could take an incentive allocation on the amount by which the returns of the fund exceeded the benchmark return. Under the facts described above, Investor X's capital account has decreased by 30%, but had Investor X made its investment in the securities comprising the S&P Investortools Municipal Bond Index, Investor X would have lost 40%. Therefore, in relative terms, Investor X's account compares favorably to the benchmark bond index and Fund B has "outperformed" the index. Fund B's general partner, however, may have difficulty paying itself an incentive allocation on the $100,000 of "profits" ($100,000 being the difference between $700,000, the actual value of Investor X's account, and $600,000, the value the account would have had had it been invested in the securities comprising the bond index). The underlying philosophy of this approach is that if the fund sponsor has targeted a return (the performance of the bond index) the sponsor should be rewarded for having exceeded the performance of that index.

On the other hand, Fund B's general partner may not take any incentive allocation. Although Fund B has outperformed the bond index, Investor X's capital account has lost value. The underlying philosophy of this approach is that the fund sponsor should not be rewarded unless it generates profits for its investors.

If Investor X's capital account increases to $1.2 million by the end of 2009, Fund B's general partner will have several choices over how the benchmark high water mechanism might work. Assuming that over the year 2009, the weighted average value of the bond index was 1%, there are four possibilities. First, Fund B's general partner could take an incentive allocation on $500,000, because Investor X's account has increased in value by $500,000 since the last year end (the excess of $1.2 million over $700,000). Also, $500,000 clearly exceeds a 1% return on the capital account balance as of the start of the year, which was $700,000 (1% of $700,000 being only $7,000). Second, Fund B's general (continued on page 8)

[1] For example, a hedge fund's NAV as of September 1, 2010 may represent the high water mark for an investor who invested in March of 2010, but may not represent the high water mark for an investor who invested in March of 2008.

How High Should Your High Water Mark Be? *(continued from page 7)*

partner could take an incentive allocation on $493,000, or $500,000 less a 1% return on the $700,000 capital account balance as of the beginning of the year. Under this approach, Fund B's general partner is entitled to a share of only those profits that exceed the benchmark. Third, Fund B's general partner could take an incentive allocation on $200,000. This approach combines the traditional high water mark feature and the benchmark and allows the general partner to a share of profits only if two conditions are satisfied: (x) the profits exceed the previous high water mark ($1 million) and (y) the profits exceed the benchmark for the year in which the incentive allocation is calculated ($7,000). Finally, Fund B's general partner could take an incentive allocation on $193,000. This assumes that the two conditions above under the third approach above are satisfied and that the general partner shares only in profits that actually exceed the benchmark return (again, $7,000).

If the S&P Investortools Municipal Bond Index's performance had been 1% in 2008, rather than -40%, one would face the additional decision as to whether the benchmark is cumulative or is applied only for the year in which the incentive allocation is taken. Thus, by tweaking our original factual assumptions and assuming that the bond index was 1% for 2008 and 1% for 2009, under the approach outlined in the last option above, the incentive allocation would be 20% of $183,000 (the excess of $200,000 over $10,000 (for 2008) and $7,000 (for 2009)) rather than $193,000 (the excess of $200,000 over $7,000 (for 2009) only).

In determining which benchmark is the best fit, a hedge fund sponsor must weigh the need to incentivize its investment professionals, traders and portfolio managers against a need to present an equitable economic deal to its investors and a proper alignment of investor interests with the general partner's interests.

**Modified High Water Mark.** Unlike the occasional dips that characterize relatively stable market activity, prolonged market downturns pose unique challenges to fund sponsors and investors. When a fund experiences significant losses, as many funds did from 2000 to 2002 and more recently during the financial crisis, fund sponsors may have difficulty retaining investment professionals, traders and portfolio managers who may look to a share of the incentive allocation as a significant part of their overall compensation.[2] Under these circumstances, a fund could implement a modified high water mark mechanism that enables it to take a share of profits even when the fund is below its traditional high water mark. Under this approach, the general partner would benefit from a reduced high water mark on any profits generated while the fund is below its traditional high water mark until the fund has generated an amount of profits sufficiently in excess (usually by some multiple) of its traditional high water mark.

For example, assume Investor X invests $1 million in Fund C on January 1, 2008 and that, as of December 31, 2008, Investor X's capital account balance has declined in value to $700,000 (meaning Investor X has a loss recovery account balance of $300,000). Under these facts, Fund C's general partner is not entitled to any incentive allocation as of the year end 2008 because the Fund has generated only losses. Further assume that, as of December 31, 2009, Investor X's capital account balance has increased to $800,000. Now Fund C has generated $100,000 of new profits, although Investor X's account is still below its traditional high water mark ($1 million). On December 31, 2009, Fund C's general partner could be entitled to an incentive allocation of 10%, for example, on the new profits attributable to Investor X's account, but would not be entitled to take its full 20% profit share until new profits in respect of Investor X's account equals a certain multiple (say, 2.5x) of the losses that were sustained. Thus, If Investor X's capital account balance were to equal $1.2 million on December 21, 2010, Fund C's general partner would still only be entitled to a 10% share of the $400,000 in profits (the excess of $1.2 million over $800,000), even though Investor X's account is once again above its traditional high water mark.

Under this approach, Fund C's general partner actually earns slightly less in aggregate incentive compensation. Because it is able to reap some modest profits over the period during which Fund C is below its traditional high water mark, however, it is better able to incentivize and reward its investment professionals, traders and portfolio managers. Furthermore, because Investor X would bear less incentive allocation over the long run, Investor X has an incentive to remain invested during this period and wait until Fund C has generated the full 2.5x of losses that were incurred.

**Private Equity Style High Water Mark.** More recently, a select minority of institutional investors have succeeded in negotiating certain private equity style protections to modify the traditional high water mark. Under this approach, a general partner clawback is grafted onto the high water mark mechanism such that if an investor's capital account balance remains below its traditional high water mark at the end of each defined period (e.g., successive three-year periods), then the fund's general partner must refund any incentive allocation taken earlier within such period. This approach ensures that the fund's general partner receives no more than 20% of the profits over any period of time that is longer than one year. This clawback protection may be appropriate for a fund seeking to impose more restrictive liquidity terms on its investors.

## Conclusion

Designing a high water mark that best fits a hedge fund involves consideration of numerous factors, including fund liquidity, the nature of the investor base, the correlation between the fund's strategy and the relevant market(s) for the asset classes in which the fund invests, and the need to provide appropriate incentives to investment professionals, traders and portfolio managers while ensuring appropriate alignment of the general partner's interests with those of the fund investors. Reaching the appropriate balance may involve a moving target that changes with market conditions and investor confidence generally. ■

[2] A portfolio manager, for example, may be faced with the prospect of waiting a two to three year period before the fund returns to its high water mark. The prospect of any incentive allocation may be even more bleak because poor returns for existing fund investors usually means no new capital is flowing into the fund. That portfolio manager, then, may find it more advantageous to pursue opportunities elsewhere, which might include joining a different firm where he or she can benefit from the profits of a fund that may be in a different part of its life cycle and may be able to capitalize on a market swing within a shorter time frame.

# Responsibility in Private Equity Investing

AMRAN HUSSEIN AND LINDSEY L. WIERSMA

Private fund managers are accustomed to addressing traditional social responsibility concerns of investors focused on avoiding investments in "sin" industries (such as alcohol, tobacco, gambling and firearms) or "bad actor" countries (such as Cuba, Iran and Sudan). Recently, however, the focus of many investors is shifting beyond negative restrictions on investment to the integration of environmental, social and corporate governance ("ESG") considerations into investment activities. Although many fund managers have often taken certain ESG considerations into consideration when evaluating investment risk, as more pension plans and other institutional investors increasingly incorporate ESG principles as core components of their business practices (including as criteria for fund manager selection), managers are facing increasing pressure from investors to include ESG considerations as primary considerations in their investment decision-making rather than as isolated risk management or ethical considerations. In today's world, investors are focused on ESG issues not solely for altruistic reasons, but because they believe that ESG-sensitive investing can have a positive impact on investment returns.

The increased focus on ESG considerations in the private equity market has been driven in large part by institutional investors and fund managers that are signatories to the United Nations Principles for Responsible Investment (the "PRI"), an initiative launched in 2006 by the United Nations Global Compact and the United Nations Environment Programme Finance Initiative, together with an international group of institutional investors. The PRI provides a framework for investors and asset managers to incorporate ESG considerations into their investment process, with the intended goal that doing so will achieve better long-term returns and more sustainable markets. A signatory[1] to the PRI pledges to apply the following six principles to its investment activities, subject at all times to the signatory's fiduciary responsibilities: (i) to incorporate ESG considerations into its investment analysis and decision-making processes; (ii) to be an active owner and incorporate ESG considerations into its ownership policies and practices; (iii) to seek appropriate disclosure on ESG considerations by the entities in which it invests; (iv) to promote acceptance and implementation of the PRI principles within the investment industry; (v) to work to enhance its effectiveness in implementing the PRI principles; and (vi) to report on its activities and progress towards implementing the PRI principles. Although the PRI does not impose legal or regulatory sanctions for non-compliance, before a fund manager or investor decides to become a signatory to the PRI, it should recognize that there may be reputational risks associated with signing up and failing to take action.

*In today's world, investors are focused on ESG issues not solely for altruistic reasons, but because they believe that ESG-sensitive investing can have a positive impact on investment returns.*

In February 2009, the members of the Private Equity Council (the "PEC")[2] adopted a set of comprehensive guidelines intended to encourage private equity industry participants to discuss principles of ESG investing more formally. Specifically, the PEC guidelines call for its members to: (i) consider environmental, public health, safety and social issues associated with target companies and portfolio companies; (ii) seek to be accessible to, and engage with, relevant stakeholders either directly or through representatives of portfolio companies; (iii) seek to grow and improve the companies in which they invest for long-term sustainability and to benefit multiple stakeholders, including on environmental, public health, social and governance issues; (iv) seek to use governance structures that provide appropriate levels of oversight in the areas of audit, risk management and potential conflicts of interest and to implement compensation and other policies that align the interests of owners and management; (v) remain committed to compliance with applicable national, state and local labor laws in the countries in which they invest; support the payment of competitive wages and benefits to employees; provide a safe and healthy workplace in conformance with national and local law; and respect the rights of employees to decide whether or not to join a union and engage in collective bargaining; (vi) maintain strict policies that prohibit bribery and other improper payments to public officials consistent with the U.S. Foreign Corrupt Practices Act, similar laws in other countries and the OECD Anti-Bribery Convention; (vii) respect the human rights of those affected by their investment activities and seek to confirm that their investments do not flow to companies that utilize child or forced labor or maintain discriminatory policies; (viii) provide timely information to their limited partners on the matters addressed in the guidelines and work to foster transparency about their activities; and (ix) encourage their portfolio companies to advance these same principles.

In July 2009, the PRI initiative published a guide entitled Responsible Investment in Private Equity: A Guide for Limited Partners[3] to help signatories apply the PRI principles to their investments in private equity. The guide outlines actions that an investor can take to incorporate ESG considerations into their due diligence processes and in their ongoing engagement with managers. A fund manager should be careful to ensure that any representations to investors in offering memoranda, fund documents or due diligence questionnaires about the manager's commitment to ESG principles accurately reflect the manager's investment policies and practices.

As investors in private investment funds pay increased attention to ESG considerations and use their relative negotiating power in the current market to put additional pressure on private fund managers to consider ESG considerations in their investment activities, it has become increasingly important for fund managers to understand the nature of ESG concerns and to be prepared to discuss with potential and existing investors their firms' ESG philosophy and commitment to dealing with such concerns. ■

[1] According to the 2009 PRI Annual Report, as of May 2009, the PRI had more than 500 signatories from 32 countries representing $18 trillion of assets under management (as of July 2010, the PRI website (www.unpri.org) reports nearly 800 signatories). Signatories include pension funds, government funds, foundations, endowments, insurance companies, investment managers and professional service providers.

[2] The members of the PEC at the time the guidelines were adopted included Apax Partners, Apollo Global Management LLC, Bain Capital Partners, the Blackstone Group, the Carlyle Group, Hellman and Friedman LLC, Kohlberg Kravis Roberts & Co., Madison Dearborn Partners, Permira, Providence Equity Partners, Silver Lake, THL Partners and TPG Capital.

[3] A copy of the guide is available at http://www.unpri.org/files/PE%20LP%20Guide%20FINAL.pdf.

# IOSCO Hedge Fund Reporting to Begin in September

PHILIP A. HEIMOWITZ

Securities regulators are expected to begin collecting data from hedge funds in an effort to assist them in assessing possible systemic risks arising from the hedge fund sector. The template[1] for the global collection of hedge fund-related information was published by the technical committee of the International Organization of Securities Commissions ("IOSCO") in February 2010.[2] The technical committee recommended that data gathering begin in September 2010.

Commissioners of the Securities and Exchange Commission (the "SEC"), in recent speeches and in testimony before Congress, have expressed their view that cooperation among securities regulators is vital to effective oversight of cross-border entities and to prevent international securities fraud. They have commented that information sharing among securities regulators and having access to the right type of information for risk monitoring purposes is critical.

## IOSCO

IOSCO is the leading international policy forum for securities regulators. The securities regulators that are members of IOSCO regulate more than 95% of the world's securities markets in over 100 jurisdictions. The IOSCO members aim to: (i) protect investors; (ii) ensure that markets are fair, efficient and transparent; and (iii) reduce systemic risk.

## Information Template

The template sets forth 11 categories of information that securities regulators expect to collect which incorporates both supervisory and systemic data. The template is not meant to be a comprehensive list of all types of information and data that regulators might seek and regulators are not restricted from requiring additional information at the domestic level. The categories of information include:

### 1 General Partner and Adviser Information

- Key principals, registered address, number of employees, number of funds, name of compliance officer, overseas offices, regulatory status, related affiliates, equity owners and relevant information about the financial health of the asset management company including, if applicable, any guarantees or agreements with parent companies
- Key service providers

### 2 Performance and Investor Information Related to Covered Funds

- Recent performance details (net and gross)
- Recent investor redemptions/subscriptions
- Net asset value vs. high water mark
- Investor classifications (i.e., institutional, fund of funds, high net worth)
- Primary marketing channels

### 3 Assets Under Management

- Group wide assets under management ("AUM") (i.e., total AUM and hedge fund AUM)

### 4 Gross and Net Product Exposure and Asset Concentration

- Material positions in various asset classes (for securities: value of long and short positions in equities, unlisted equities, corporate bonds, sovereign bonds, convertible bonds, loans, securities credit products and other structured products; for derivatives: long and short credit default swap positions, the gross value of foreign exchange, interest rate and other derivatives and the geographic split of assets within these classes)

### 5 Gross and Net Geographic Exposure

- High level regional investment focus ( e.g., United States, Europe, Asia (ex-Japan), Japan, Global and Global Emerging Market)
- Assets by the underlying currency

### 6 Trading and Turnover Issues

- Turnover in various asset classes
- Clearing mechanisms for balance sheet instruments and derivatives

### 7 Asset/Liability Issues

- Liquidity of assets
- Investor liquidity demands
- Extent of term financing
- Use of side pockets
- Ability to gate or suspend funds and any restrictions currently in place

### 8 Borrowing

- Value of borrowings by source (prime broker, repo, stock lending, off balance sheet and unsecured)
- Borrowing from regulated vs. unregulated entities

### 9 Risk Issues

- Unencumbered cash
- Various risk measures used by hedge fund managers
- Description of mechanisms to assess risk (e.g., stress tests)

### 10 Credit Counterparty Exposure

- Net credit counterparty risk, identifying primary counterparties and identities and locations of those counterparties
- Extent of rehypothecation

### 11 Other

- Complexity (e.g., gross size of options book and number of open positions)
- Concentration of positions as a percentage of gross market value

The technical committee has recommended that the first data-gathering exercise should be carried out on a best efforts basis.

*(continued on page 11)*

[1] The template may be found at: http://www.iosco.org/news/pdf/IOSCONEWS179.pdf.

[2] The Technical Committee is a specialized working group within IOSCO that is made up of 18 agencies that regulate some of the world's larger, more developed and internationalized markets. Its objective is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. The members of the Technical Committee are the securities regulatory authorities of Australia, Brazil, China, France, Germany, Hong Kong, India, Italy, Japan, Mexico, the Netherlands, Ontario, Quebec, Spain, Switzerland, United Kingdom and the United States.

IOSCO Hedge Fund Reporting to Begin in September *(continued from page 10)*

### Practical Limitations

IOSCO does not have the ability to promulgate regulations and depends on its member securities regulators to adopt regulations in accordance with the governing law of their home jurisdiction. The ability of a securities regulator in a particular country to adopt rules and the reach of the disclosure required under those rules will be subject to many factors, including the political climate in that jurisdiction.

### The SEC

The Private Fund Investment Advisers Registration Act of 2010 requires the SEC to issue rules which require investment advisers to private funds to file such reports as the SEC deems necessary for the protection of investors and for the assessment of systemic risks. Having played an active role as a lead member of IOSCO, it is likely that the rules that the SEC adopts will require such reports to contain much of the information proposed by IOSCO to be included in the template. ■

## Update on the EU Directive on AIFM

JYOTI SHARMA AND LYUDMILA BONDARENKO

In April 2009, the Commission of the European Union (the "Commission") proposed a Directive on Alternative Investment Fund Managers (the "Directive"). If it becomes law, the Directive has the potential to impose fundamental changes and burdens on investment industry participants located in the European Union (the "EU") or serving clients from the EU, including hedge funds and private equity funds regardless of the domicile of such funds. A U.S.-domiciled investment fund manager would be subject to the Directive if it were to market investment funds in the EU, regardless of the funds' jurisdiction of establishment.

The key regulatory components of the Directive include obligations for managers of "alternative investment funds" to: (i) register; (ii) disclose their activities to regulators and investors; (iii) institute robust governance control and liquidity management systems; (iv) engage third parties as custodians; and (v) comply with restrictions on leverage, conduct of business obligations and capital requirements. The Directive also envisions close international cooperation between the EU regulators and their counterparts in other countries, and expects legislation of other countries to meet certain standards, as a pre-requisite for permitting funds from such countries to operate within the EU. Such cooperation and legislation may be impracticable with respect to the U.S., which could result in the U.S.-domiciled funds being unable to access the EU markets.

The Council of the EU (the "Council") and the Parliament of the EU (the "Parliament") must agree on an identical text of the Directive before it becomes law, with the vote of full Parliament being the final step. The Council and a committee of the Parliament each passed its own version of the Directive in May 2010. The Commission, the Council and the Parliament's representatives have been engaged in a tri-party dialogue in an attempt to reconcile the two versions of the Directive. As of the end of June 2010, the parties have been unable to reach an agreement and the Parliamentary vote on the Directive has been delayed until the second Parliamentary session in September 2010. If the Directive is passed by the Parliament in September, the Commission will draft detailed implementing regulations that will expand and clarify the Directive. Each member state of the EU will be obligated to take action on the national level to transpose the Directive into national law within two years of the Directive's adoption, and the Directive will take effect once it has been transposed into national law. If enacted in its current form, particularly as proposed by the Parliament, investment managers located in the EU or serving clients from the EU will need to consider the Directive's impact on their business. ■

## Proposed Legislation Affecting Private Funds

### Federal Taxation of Carried Interest

For several years, there has been interest on the part of Congress and, more recently, the Obama administration in changing the taxation of income derived from a partner's carried interest in certain investment funds organized as partnerships. In May, the House of Representatives passed legislation that would change substantially the treatment of income from partnership carried interests by characterizing a portion of it as ordinary income. For individual taxpayers, once it has been fully phased in by 2013, the House legislation would treat 75% of carried interest as ordinary income and the remaining 25% as it is treated under current law (i.e., based on the underlying income of the fund in question). Until 2013, the percentages would be 50% and 50%, respectively. A version of the legislation, with slightly different provisions, is currently stalled in the Senate. As the Senate will be in recess from August 9 through September 12, it is unlikely that there will be further developments with respect to this legislation until mid-September.

### New York State Abandons Proposal to Tax Non-Resident Carried Interest at Ordinary Income Rates

On August 3, 2010, the New York State Assembly and Senate unanimously voted down a measure that would have taxed carried interest as ordinary income for non-New York residents who work in New York State. ■

# Newly Enacted Laws Affecting Private Funds

## Dodd-Frank Wall Street Reform and Consumer Protection Act

### Private Fund Investment Advisers Registration Act

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law. Included in Title IV of the Dodd-Frank Act is the Private Fund Investment Advisers Registration Act of 2010 (the "Registration Act"), which eliminates (i) the "private adviser exemption" from Securities and Exchange Commission (the "SEC") registration currently contained in Section 203(b)(3) of the Investment Advisers Act of 1940 (the "Advisers Act") for investment advisers who do not hold themselves out to the public as investment advisers and have fewer than 15 clients; and (ii) the intrastate exemption from SEC registration for investment advisers with any private fund client. As a result of the foregoing, many investment advisers to private funds (with some exceptions) will be required to register with the SEC. For a description of the registration and reporting requirements under the Registration Act, please see our article entitled *"Registration and Reporting Implications of the Private Fund Investment Advisers Registration Act"* beginning on page 4.

Immediately upon enactment of the Registration Act, the net worth standard for an "accredited investor" that is a natural person, as set forth in Rules 215 and 501(a)(5) of the Securities Act of 1933 (the "Securities Act"), was adjusted to exclude from the calculation of net worth the "value of the primary residence" of the investor. Pending implementation of the changes to the SEC's rules required by the Registration Act, the SEC issued Compliance and Disclosure Interpretations clarifying that the related amount of indebtedness secured by the primary residence up to its fair market value may also be excluded. Indebtedness secured by the residence in excess of the value of the home, however, should be considered a liability and deducted from the investor's net worth. As a result, investment advisers should update their subscription booklets to reflect this change. The SEC is required to review and modify such definition periodically.

Within one year after July 21, 2010 (and periodically thereafter), the SEC is required to adjust for inflation the net worth and/or asset-based qualifications applicable to a "qualified client" under the Advisers Act.

Other than as specifically noted above, the Registration Act becomes effective on July 21, 2011, during which time the SEC is expected to adopt rules and regulations providing procedures for registration and reporting. Investment advisers to private funds may voluntarily register with the SEC during this one-year period.

Please see our June 30, 2010 client memorandum entitled *"House-Senate Conference Committee Approves Private Fund Investment Advisers Registration Act"* for further information on this topic.

### The Volcker Rule

Section 619 of the Dodd-Frank Act contains the so called "Volcker Rule" which prohibits any "banking entity" from engaging in proprietary trading or sponsoring or investing in hedge funds or private equity funds, subject to limited exceptions. "Banking entity" is defined to include any insured depository institution, any company that controls an insured depository institution or that is regulated as a bank holding company, and any affiliate or subsidiary of any such entity.

The Volcker Rule generally prohibits a banking entity from acquiring or retaining any equity, partnership or other ownership interest in or sponsoring any hedge fund or private equity fund. "Sponsoring" is defined broadly as (i) serving as a general partner, managing member or trustee of a fund; (ii) selecting or controlling a majority of the directors, trustees or management of the fund; or (iii) sharing with a fund, for corporate, marketing, promotional or other purposes, the same name or a variation of the same name. "Hedge fund" and "private equity fund" are defined to include any issuer that would be an investment company subject to registration under the Investment Company Act of 1940, but for an exemption provided by Section 3(c)(1) or Section 3(c)(7) thereunder, and any other issuer that the regulators determine, by rule, should be subject to the Volcker Rule.

The Dodd-Frank Act provides exceptions for the following permitted activities:

- organizing and offering a hedge fund or private equity fund, *(continued on page 13)*

# Recent Litigation Affecting Private Funds

## FIDUCIARY DUTY TO INVESTORS

***United States v. Mark D. Lay***[1]

On July 14, 2010, the Sixth Circuit Appeals Court upheld the conviction of hedge fund manager, Mark D. Lay, on one count of investment adviser fraud and multiple counts of mail and wire fraud. Based on testimony presented at his trial, a District Court jury found Mr. Lay guilty on all counts for fraud in violation of Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act"), which generally prohibits an investment adviser from using the mails or instrumentalities of interstate commerce for purposes of engaging in a scheme to defraud any client. As a result of his conviction, Mr. Lay was ordered to (i) pay $212 million in restitution (reflecting losses caused by Mr. Lay's over-leveraging); (ii) forfeit $590,526.23 (representing amounts obtained from Mr. Lay's mail and wire fraud); and (iii) serve 144 months of imprisonment.

Mr. Lay's fraud convictions in the District Court were related to the loss by the Ohio Bureau of Workers' Compensation (the "Investor") of $214 million of its $225 million investment in a hedge fund vehicle, the Active Duration Fund, created by Mr. Lay in 1998 (the "ADF Fund"). The prosecution argued that $212 million of the $214 million in losses were sustained as a result of Mr. Lay ignoring a 150% leverage guideline contained in the ADF Fund's governing documents and Mr. Lay's failure to disclose the frequency and extent of leverage employed in his communications with the Investor.

Mr. Lay began serving as investment adviser to the Investor in 1992 in connection with its investment in a long term bond fund (the "Long Fund"). In late 2003, the Investor shifted $100 million of its investment in the Long Fund to the ADF Fund becoming the ADF Fund's first and only investor. After experiencing a $7 million loss in early 2004, the Investor approached Mr. Lay to discuss the loss and ultimately decided to invest an additional $100 million in the ADF Fund. Thereafter, the ADF Fund continued to lose value and, in late 2004, the Investor terminated its interest in the ADF Fund after investing an additional $25 million in an attempt to avoid losing its entire investment.

In reliance on Goldstein v. SEC,[2] Mr. Lay's primary argument both in the District Court and on appeal was that, as a hedge fund adviser, he did not owe a fiduciary duty to the Investor, but rather that his fiduciary duty ran solely to the ADF Fund. The Appeals Court dismissed this argument on the basis that that Mr. Lay's interpretation of Goldstein was too broad, *(continued on page 13)*

[1] 2010 WL 2757123 (6th Cir. July 14, 2010).

[2] 451 F. 3d 873 (D.C. Cir. 2006).

## Newly Enacted Laws Affecting Private Funds *(continued from page 12)*

including sponsoring such a fund, as long as all of the following conditions are met:

(i) the banking entity provides bona fide trust, fiduciary or investment advisory services;

(ii) the fund is organized and offered only in connection with the provision of such services and is only offered to customers of such services of the banking entity;

(iii) the banking entity does not have an equity or other ownership interest in the fund except for the following de minimis investments:

- seed investments to establish the fund and provide the fund with sufficient initial equity for investment to attract unaffiliated investors; and
- other de minimis investments;

provided that, in making either of the above investments, (x) the banking entity must actively seek unaffiliated investors to reduce its ownership interest to not more than 3% of the total ownership interest of the fund within one year of the establishment of the fund (which period of time may be extended for up to two additional years upon application to the Federal Reserve); and (y) the banking entity's aggregate interests in all funds in which it is permitted to invest may not exceed 3% of its Tier 1 capital;

(iv) the banking entity does not enter into covered transactions (as defined in Section 23A of the Federal Reserve Act, these transactions generally include providing loans or guarantees to funds and purchasing fund assets or securities) with the funds it organizes and offers and complies with the requirements of Section 23B of the Federal Reserve Act, which imposes restrictions on transactions between banks and their affiliates;

(v) the banking entity does not guarantee, assume or otherwise insure the obligations or performance of the fund or any other hedge fund or private equity fund in which the fund invests;

(vi) the banking entity does not share the same name or a variation of the same name with the fund;

(vii) no director or employee of the banking entity takes or retains an equity or other ownership interest in the fund, except for any director or employee who is directly engaged in providing investment advisory or other services to the fund; and

(viii) the banking entity discloses to prospective and actual investors that the fund's losses are borne by the fund's investors and not by the banking entity;

- investing in small business investment companies or certain other investments that are designed to promote the "public welfare" or that are qualified rehabilitation expenditures;
- investing in or sponsoring a hedge fund or private equity fund solely outside the United States, provided that the banking entity is not directly or indirectly controlled by a banking entity organized in the United States and the interests in the fund are not offered or sold to a resident of the United States; and
- engaging in such other activities as the appropriate federal banking agencies, the SEC and the Commodity Futures Trading Commission determine, by rule, would "promote and protect" the safety and soundness of the banking entity and the financial stability of the United States.

These exceptions for permitted activities are subject to the same limitations contained in the Volcker Rule with respect to proprietary trading, i.e., such transactions must not give rise to material conflicts of interest, involve high-risk assets or strategies or pose a threat to the banking entity or the U.S. financial system.

The Dodd-Frank Act also requires the Federal Reserve to adopt rules imposing additional capital requirements and quantitative limits on systemically important nonbank financial companies that engage in proprietary trading or sponsor or invest in hedge funds or private equity funds.

Please see our July 14, 2010 client memorandum entitled *"The Volcker Rule"* for further information on this topic.

### ■ Reg D Offerings

Rule 506 of Regulation D of the Securities Act creates a safe harbor allowing issuers to make private placements under Section 4(2) without the offering being deemed "public" and without having to comply with the securities laws of each specific state in which they offer or sell securities. Section 926 of the Dodd-Frank Act requires the SEC to adopt rules by July 21, 2011, that will disqualify offerings from the protections of Regulation D under the Securities Act if such offerings are made by certain "bad actors." The Dodd-Frank Act requires that these new rules must be substantially similar to Rule 262 of the Securities Act. The Dodd-Frank Act specifies that the new rules must disqualify an offering or sale of securities as a Regulation D offering where the person offering the securities: (i) is subject to a final order by a state securities, banking or insurance authority, a federal *(continued on page 14)*

## Recent Litigation Affecting Private Funds

*(continued from page 12)*

noting that the court in Goldstein did not hold that a hedge fund investor could never be a client of a hedge fund adviser, or be owed a fiduciary duty by such adviser, for purposes of criminal liability under the fraud provisions of the Advisers Act. In upholding Mr. Lay's conviction and finding that the characteristics of an adviser-client relationship did exist as between Mr. Lay and the Investor with respect to the ADF Fund, the Appeals Court emphasized the atypical nature of the relationship that existed between Mr. Lay and the Investor with respect to the Long Fund and the ADF Fund. Specifically, the Appeals Court noted that Mr. Lay did not dispute the existence of an adviser-client relationship with respect to the Long Fund which pre-dated the Investor's investment in the ADF Fund. Second, based on Mr. Lay's pre-existing adviser-client relationship with the Investor in respect of the Long Fund, a rational trier of fact could find that a second adviser-client relationship was established with respect to the ADF Fund. In fact, a representative of the Investor testified that one of the primary reasons for investing in the ADF Fund, which included shifting $100 million of its existing investment in the Long Fund to the ADF Fund, was to diversify its existing investment with Mr. Lay. Third, the Investor was the sole investor in the ADF Fund and, through its regular and direct communication with Mr. Lay, assumed an active role in connection with such investment.

The Appeals Court also found no merit in Mr. Lay's argument that the 150% limit on leveraging was simply a guideline rather than a strict limitation, noting that it nonetheless did not contemplate the use of leverage in excess of 150% in two-thirds of trades and in excess of 1,000% in one-fifth of trades. Based on these findings, the Appeals Court reasoned that a rational trier of fact could have found Mr. Lay guilty of fraud based on the misrepresentation of its leveraging activity and the failure to disclose such activity to the Investor.

With respect to Mr. Lay's conviction for mail and wire fraud, the Appeals Court also found the evidence sufficient to establish that Mr. Lay had used interstate mail or wires in furtherance of a scheme with the intent to deprive the Investor of money by misrepresenting the extent of his over-leveraging and omitting material information related thereto in his reports to the Investor. In particular, the Appeals Court recognized that the trade confirmations, emails and faxes through which Mr. Lay conducted the fraud satisfied the mailing and wiring requirement since they were designed to create a false sense of security and to ultimately postpone the Investor's complaint. Although it had no effect on the outcome of the present case, it should be noted that one judge sitting on the Appeals Court panel dissented in part on the basis that there was no proof in the record, apart from trade confirmation slips, which were only mailed between banks to reflect trades, to support the claim that Mr. Lay had made any other interstate mailing containing a misrepresentation.

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## Newly Enacted Laws Affecting Private Funds *(continued from page 13)*

banking agency or the National Credit Union Administration that (a) bars the person from (1) association with any entity regulated by such authority, (2) engaging in the business of securities, insurance or banking, or (3) engaging in savings association or credit union activities, or (b) constitutes a final order based on a violation of any law or regulation that prohibits fraudulent, manipulative or deceptive conduct within the 10-year period ending on the date of the filing of the Form D; or (ii) has been convicted of any felony or misdemeanor in connection with the purchase or sale of any security or involving the making of any false filing with the SEC.

### Incentive-Based Compensation

Section 956 of the Dodd-Frank Act directs federal regulators, including the SEC, by April 2011, to jointly prescribe regulations that would require "covered financial institutions," including investment advisers, to disclose to the appropriate regulator the structures of their incentive-based compensation arrangements. No reporting of the actual compensation of particular individuals would be required. Further, such regulators must jointly issue rules to prohibit any incentive-based payment arrangement that they determine will encourage inappropriate risks by the covered financial institutions by providing their executive officers, employees, directors or principal shareholders with excessive compensation, fees or benefits or that could lead to material financial loss to the institution. Covered financial institutions with assets of less than $1 billion are excluded from these provisions.

## SEC Adopts Pay to Play Rule

On June 30, 2010, the SEC adopted a new rule under the Advisers Act to curb "pay to play" practices by certain investment advisers. Pay to play refers to the practice of making campaign contributions to elected officials in an attempt to influence the awarding of contracts for the management of public pension plan assets and similar government investment accounts. Newly adopted Rule 206(4)-5 entitled "Political Contributions by Certain Investment Advisers" (the "Pay Rule") prohibits an investment adviser from:

- providing advisory services for compensation to a government entity for two years after the adviser, or certain of its executives or employees, makes a contribution to certain elected officials or candidates who are in a position to influence the selection of the adviser;
- providing or agreeing to provide, directly or indirectly, payment to any third party (i.e., a placement agent) for solicitation of advisory business from any government entity on behalf of such adviser, unless the third party is an SEC-registered investment adviser or an SEC-registered broker-dealer, in each case, subject to similar pay to play restrictions; and
- coordinating or soliciting from others (a practice known as "bundling") campaign contributions to certain elected officials who are in a position to influence the selection of the adviser or payments to certain political parties in the state or locality where the adviser is seeking government business.

The Pay Rule becomes effective September 12, 2010; however, the restrictions on political contributions will only apply to contributions made after March 12, 2011. Compliance with the ban on the use of unregulated placement agents is required by September 12, 2011. The SEC is providing time for the Financial Industry Regulatory Authority to propose a similar rule covering broker-dealers. Please see our July 9, 2010 client memorandum entitled *"SEC Adopts Rule Regarding Political Contributions by Investment Advisers"* for further information on this topic.

## SEC Adopts Amendments to Form ADV, Part 2

On July 28, 2010, the SEC published its release[1] discussing amendments recently adopted by the SEC to Part 2 of Form ADV, and related rules under the Advisers Act, which require registered investment advisers to provide clients and prospective clients with a brochure and brochure supplements written in plain English, including clearly written, meaningful, current disclosure of the business practices, conflicts of interest and background of the investment adviser and its advisory personnel. The brochures must be filed electronically with the SEC and will be made available to the public through the SEC's website.

Currently, Part 2 requires investment advisers to respond to a series of multiple-choice and fill-in-the-blank questions organized in a "check-the-box" format. Unfortunately, that format frequently does not correspond well to an investment adviser's business. And, in some cases, the required disclosure may not describe the investment adviser's business or conflicts in a user-friendly manner. *(continued on page 15)*

[1] For a copy of the SEC's release, see http://www.sec.gov/rules/final/2010/ia-3060.pdf.

## Recent Litigation Affecting Private Funds

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### DISCLOSURE OF LP LIST

***Brown Investment Management, L.P. v. Parkcentral Global, L.P.***[3]

On May 24, 2010, the Delaware Chancery Court denied a stay pending appeal of the court's previous ruling that the defendant fund, Parkcentral Global, L.P. ("Parkcentral") was required to provide plaintiff limited partner, Brown Investment Management, L.P. ("Brown"), a list of all other limited partners of Parkcentral. In this case, a group of limited partners, not including Brown, had initiated a suit against Parkcentral in Texas federal court after the hedge fund suffered significant losses, leading to the close of its business. Brown, which had lost its full $16 million investment, requested the list of limited partners for the stated purposes of communicating with other limited partners "about the failure of Parkcentral, potential wrongdoing at Parkcentral, and the Texas litigation." Parkcentral refused to provide the limited partner list, arguing, among other things, that the Gramm-Leach-Bliley Act of 1999 (the "Gramm-Leach-Bliley Act") preempted rights under state law to provide information about other limited partners. The Delaware Chancery Court in this instance extended the ruling in Arbor Place L.P. v. Encore Opportunity Fund, L.L.C.,[4] holding that as with Arbor, where the court held that the Gramm-Leach-Bliley Act did not preempt rights under the Delaware Limited Liability Company Act to provide a list of its members to another member, the Gramm-Leach-Bliley Act does not preempt rights under the Delaware Revised Uniform Limited Partnership Act, Section 17-305, which provides, in part, that a limited partner has "the right, subject to such reasonable standards . . . . to obtain from the general partner from time to time upon reasonable demand for any purpose reasonably related to the limited partner's interest as a limited partner. . . a current list of the name and last known business, residence or mailing address of each partner . . . ." In denying the stay, the court emphasized that Parkcentral "had not done anything to adopt a policy regarding the confidentiality of its list of limited partners beyond issuing the period privacy notices required by the Gramm-Leach-Bliley Act" and lacked a good faith basis to believe that providing such a list would harm Parkcentral, especially given the fact that Parkcentral was no longer a going concern. The Delaware Chancery Court distinguished an earlier case, Wynnefield Partners Small Cap Value, L.P. v. Niagara Corp.,[5] in which instance a stay pending appeal was granted to the corporation in question that was in the midst of a going-private transaction. The Delaware Chancery Court therefore left open the possibility that the decision may have differed had Parkcentral remained an active fund and had additional facts to bolster its arguments around harm to the partnership or other limited partners, such as additional policies regarding confidentiality of other limited partners' identities and addresses.

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[3] 2010 Del. Ch. LEXIS 112 (May 24, 2010).

[4] 2002 Del. Ch. LEXIS 102 (Del. Ch. Jan. 29, 2002).

[5] 2006 Del. Ch. LEXIS 144 (Del. Ch. Aug. 9, 2006).

## Newly Enacted Laws Affecting Private Funds *(continued from page 14)*

Under the new rules, investment advisers are required to prepare a narrative, plain English, brochure, presented in a consistent, uniform manner that will make it easier for clients to compare different investment advisers' disclosures. Investment advisers must deliver the brochure to a client before or at the time the investment adviser enters into an advisory contract with the client. In addition, investment advisers must provide each client an annual summary of material changes to the brochure and either deliver a complete updated brochure or offer to provide the client with the updated brochure. The new brochure addresses those topics the SEC believes are most relevant to clients, including (i) advisory business; (ii) fees and compensation; (iii) performance-based fees and side-by-side management; (iv) methods of analysis, investment strategies and risk of loss; (v) disciplinary information; (vi) code of ethics, participation or interest in client transactions and personal trading; and (vii) brokerage practices. An investment adviser is also required to deliver brochure supplements to clients and prospective clients providing them with information about the specific individuals who will provide services to the clients. The supplement will contain brief résumé-like disclosure about the educational background, business experience, other business activities and disciplinary history of the individual, so that the client can assess the person's background and qualifications. It will also include contact information for the person's supervisor in case the client has a concern about the person.

Investment advisers that are currently registered, with fiscal years ending on or after December 31, 2010, must file a brochure that complies with the new rules by March 31, 2011. New investment advisers filing for registration after January 1, 2011 must file a brochure that complies with the new requirements with their application for registration.

### New York City Adopts Additional Pay to Play Policies

On June 22, 2010, New York City Comptroller John Liu announced additional transparency and disclosure initiatives implemented by his office relating to money managers seeking to do business with the Teachers' Retirement System ("TRS"), the New York City Employees' Retirement System ("NYCERS") and the Board of Education Retirement System ("BERS"). Comptroller Liu also announced that the current ban on the use of placement agents will remain in place. Effective July 1, 2010 (Fiscal Year 2011), there will be new policies relating to disclosure in the due diligence investment process at TRS, NYCERS and BERS (collectively, the "Systems"):

- Investment managers must certify in writing that they have not given any gifts to any employee in the Comptroller's Office, and have complied with NYC Conflict of Interest Board gift restrictions for the Systems and their respective Boards of Trustees;
- Investment managers must disclose all contacts with employees of the Comptroller's Office regarding new investments as well as contacts with other individuals, such as members of the Boards of Trustees, involved in the investment decision-making process;
- Investment managers must certify/agree to the following:
  - No placement agent was used in connection with securing the Systems' commitment to any private equity investment transaction;
  - Full disclosure of all fees and terms relating to any firm retained to provide marketing or placement services for transactions that are not covered by the placement agent ban;
  - Marketing/placement fees, if any, shall be fully borne by the investment manager;
  - They have read and complied with Chapter 68 of the NYC Conflict of Interest Board rules and have not caused any employee of the Comptroller's Office or any member of the Boards of Trustees or employee of NYCERS or TRS to breach them in any way; and
  - Agree that Systems may terminate an investment commitment or contract, and any obligations to pay future management or performance fees, for violation of the Systems' placement agent policy and related disclosure requirements.
- Comptroller Liu has voluntarily agreed not to accept any campaign contributions from investment managers and their agents doing business with, or seeking to do business with, the New York City pension systems. ■

## Recent Litigation Affecting Private Funds
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### EARLY WITHDRAWAL REQUEST DENIED

***Wimbledon Fund LP-Absolute Return Fund Series v. SV Special Situations Fund LP*** [6]

On June 14, 2010, in response to a summary judgment motion by Wimbledon Fund LP-Absolute Return Fund Series ("Wimbledon") and cross-motion by SV Special Situations Fund LP ("SV Fund"), the Delaware Chancery Court held that a fund-wide withdrawal suspension applied to a limited partner that had prematurely requested a withdrawal prior to the announcement of the suspension, noting that its request was made prior to the end of the agreed-upon lock-up period. In connection with the investment by Wimbledon in the SV Fund on October 1, 2007, Wimbledon bound itself to the limited partnership agreement of SV Fund. The Delaware Chancery Court highlighted four main provisions in the SV Fund's agreement that determined the holding of this case: (i) limited partners could only withdraw funds without the general partner's consent as of June 30th or December 30th of any fiscal year, but in any event only after the one-year anniversary of such limited partner's initial investment; (ii) the general partner could suspend all capital withdrawals of partners under certain enumerated circumstances; (iii) the general partner could waive or modify withdrawal terms pursuant to a written agreement with the limited partner; and (iv) modifications or waivers of the agreement in general required a signed writing. In February 2008, Wimbledon requested to withdraw its investment as of the next redemption date, June 30, 2008. SV Fund's first and only response was an acknowledgment in September 2008 that it had received Wimbledon's request to withdraw funds as of June 30, 2008. In October 2008, SV Fund notified all of its partners that it was suspending all future and pending withdrawal requests. The Delaware Chancery Court held that: (i) SV Fund's September 2008 acknowledgement of the premature withdrawal request did not constitute an express consent to an early withdrawal as of June 30, 2008; (ii) that Wimbledon was still a limited partner of the SV Fund when the suspension notice was issued because express consent for withdrawal was not given; and (iii) that therefore the fund-wide suspension applied to Wimbledon's withdrawal request regardless of the fact that the request was made prior to receipt of the suspension notice. In coming to this holding, the Delaware Chancery Court emphasized the high hurdle of demonstrating that a party had waived its contractual rights, noting that "silence is never sufficient to establish a waiver where the party has no duty to speak" and further that such a waiver needed to be an "unequivocal indication" of a waiver of rights. The Delaware Chancery Court further noted that the SV Fund's agreement did not restrict the suspension rights to only prospective withdrawals and that therefore by its plain terms, the SV Fund's partnership agreement did not preclude an application of the suspension to pending withdrawal requests.

[6] C.A. No. 4780-VCS (Del. Ch. June 14, 2010).

# Investment Management News

MARKET AND LEGAL UPDATE

## INVESTMENT MANAGEMENT GROUP OFFICES & CONTACTS

**NEW YORK**
1285 Avenue of the Americas
New York, NY 10019-6064
Tel: 212-373-3000
Fax: 212-757-3990

**Robert M. Hirsh**
212-373-3108
rhirsh@paulweiss.com

**Marco V. Masotti**
212-373-3034
mmasotti@paulweiss.com

**Robert D. Goldbaum**
212-373-3028
rgoldbaum@paulweiss.com

**Steven J. Williams**
212-373-3257
swilliams@paulweiss.com

**Mitchell L. Berg**
212-373-3048
mberg@paulweiss.com

**Yvonne Y.F. Chan**
212-373-3255
ychan@paulweiss.com

**Philip A. Heimowitz**
212-373-3518
pheimowitz@paulweiss.com

**Amran Hussein**
212-373-3257
ahussein@paulweiss.com

**Stephanie R. McCavitt**
212-373-3558
smccavitt@paulweiss.com

**Jennifer A. Spiegel**
212-373-3748
jspiegel@paulweiss.com

**LONDON**
Alder Castle
10 Noble Street
London EC2V 7JU
United Kingdom
Tel: (44-20) 7367-1600
Fax: (44-20) 7367-1650

**Mark S. Bergman**
(44-20) 7367-1601
mbergman@paulweiss.com

**David K. Lakhdhir**
(44-20) 7367-1602
dlakhdhir@paulweiss.com

**HONG KONG**
12th Floor
Hong Kong Club Building
3A Chater Road, Central
Hong Kong
Tel: (852) 2846-0300
Fax:(852) 2840-4300

**John E. Lange**
(852) 2846-0333
jlange@paulweiss.com

**TOKYO**
Fukoku Seimei Building
2-2 Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
Tel: (81-3) 3597-8101
Fax: (81-3) 3597-8120

**Kaye N. Yoshino**
(81-3) 3597-6303
kyoshino@paulweiss.com

Paul | Weiss

www.paulweiss.com

**Investment Management News Editors:**
Marco V. Masotti
Karen J. Hughes
Michael S. Hong

*Please contact funds@paulweiss.com to be added to our mailing list or for further information.*