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Investment Funds News

MARKET AND LEGAL UPDATE

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Paul, Weiss Investment Funds Group
The funds 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 funds group is also involved in acquiring, merging and advising investment management businesses. In addition, the funds group represents a diverse group of domestic and foreign investors in connection with their investments in private investment funds.

Separately Managed Accounts

MARCO V. MASOTTI AND JYOTI SHARMA

Demand Increasing for Separately Managed Accounts

Faced with gates, suspension events and other redemption restrictions in pooled investment vehicles, investors are increasingly approaching investment managers to establish separately managed accounts ("SMAs"). SMAs are individualized investment portfolios that are separately managed for each investor by an investment manager. Historically, given the administrative burdens involved in managing an SMA (including additional reporting obligations), investment managers were inclined to establish SMAs for only their largest clients, such as pension funds, endowments and funds of funds. However, investment managers now seem willing to organize SMAs for smaller investors as they watch investor capital dissipate through redemptions and face an increasingly difficult fund raising environment. An SMA offers an investment manager the opportunity to accommodate each client's specific needs without the same level of conflicting obligations to other clients and, as a result, an investment manager may offer an investor preferential reporting, liquidity or economic terms without the same level of concern about "most favored nations" provisions with other investors. In light of these considerations and the current climate, a growing number of SMAs are being established by investment managers for contributions of as little as $50 to $100 million.

Structure

An SMA is typically structured as either an "Investment Account" or a "Separate Vehicle."

- In the case of an Investment Account, an investor typically contributes cash, securities and/or other assets into an account established on behalf of the investor for management by the investment manager, or the investor extends direct discretionary authority to the investment manager in respect of existing assets. The relationship between the investor and the investment manager is governed by an Investment Management Agreement.
- In the case of a Separate Vehicle, the investment manager creates a special purpose investment vehicle with the investor as the sole limited partner or shareholder. The investment manager typically controls and manages the Separate Vehicle under the terms of the constituent documents of the Separate Vehicle (including an Investment Management Agreement), and the Separate Vehicle maintains direct ownership of the assets.
- From the perspective of the investment manager, an SMA structured as a Separate Vehicle may be preferable to an SMA structured as an Investment Account for a number of reasons.

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Separately Managed Accounts

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Commonly Negotiated Terms: Investment Mandate and Fees

In general, an investor and investment manager will negotiate the investment mandate of the SMA. In many cases, the investor negotiates detailed written investment guidelines to ensure that the investments are consistent with the liquidity and return characteristics associated with the investor's investment objective. In addition, the fees associated with an SMA often include both management fees and incentive fees (or incentive "allocation" with respect to an SMA structured as a Separate Vehicle). The investor may bear an annual management fee equal to a certain percentage (often between 0.5% and 2%) of the net asset value of the assets attributable to the SMA. If the investor terminates the SMA or makes withdrawals from the SMA within a certain period of time after formation (for example, 12 to 18 months), the investment manager may be entitled to an additional management fee equal to the management fee (calculated based on the original contributions to the SMA) that would have been payable by the investor for such period of time had the SMA not been terminated or withdrawals not been made. The investor may also bear an annual incentive fee or allocation equal to a certain percentage (say 5% to 20%) of the net profits of the SMA. The incentive fee or allocation is typically subject to a "high water mark" and, in some cases, a hurdle rate or preferred return (which may be linked to a relevant benchmark).

The Investor's Perspective: Transparency and Liquidity Advantages

From the perspective of an investor, an SMA offers the investor its own tailored fund with greater transparency and fewer restrictions on liquidity. With respect to transparency, reports provided to an investor are often customized to satisfy the specific needs of the investor. An investment manager and an investor generally agree on precisely the type of information that will be provided to the investor on a daily, weekly, monthly, quarterly or annual basis. The investment manager may be required to report to the investor all transactions involving the investment assets, a list of all accounts, the investment performance of the portfolio, the net asset value of the SMA and related information. With respect to liquidity, an SMA may offer an investor daily, weekly or monthly liquidity terms (without lengthy notice periods, gate provisions, lock-up periods and other similar features typical of hedge funds). In many cases, an investor is able to withdraw all or any portion of the assets from the SMA upon prior notice to the investment manager (anywhere from 5 to 90 days depending on the nature of the investment assets).

	SEPARATE VEHICLE	INVESTMENT ACCOUNT
Control:	The investment manager typically controls the Separate Vehicle, which provides the investment manager with a greater degree of control over the management, disposition and liquidation of the assets compared to an Investment Account.	The investor technically owns the assets and typically negotiates a greater degree of control over the management, disposition and liquidation of the assets compared to a Separate Vehicle.
Performance Allocation:	The performance-based compensation to the investment manager may be structured as an "allocation" to take advantage of the capital gains tax rate.	The performance-based compensation to the investment manager is typically structured as a fee (and not as an "allocation") and therefore taxed at ordinary income rates.
Indemnification:	The indemnification protection is generally consistent with a pooled investment fund (i.e., generally, indemnification relating to any claims other than for gross negligence, fraud or willful misconduct).	The indemnification protection is often less or more limited than the protection in a Separate Vehicle. In certain cases, the investor will refuse to agree to indemnify the investment manager and its related persons. Moreover, the investment manager may be required to indemnify the investor in connection with the manager's breaches or actions.
Tax Structure:	The investment manager has flexibility to structure the Separate Vehicle in a tax-efficient or advantageous manner to address the diverse needs of the investor.	The investment manager simply establishes an account on behalf of the investor without always having the benefit or flexibility to establish the account in a tax-efficient or advantageous manner.
Expenses:	The expenses borne by the investor are generally consistent with the expenses in a pooled investment fund.	The expenses borne by the investor are often more limited than the expenses borne by an investor in a Separate Vehicle.
Counterparty Arrangements:	The investment manager typically has discretion to negotiate arrangements with prime brokers and other trading arrangements.	The investment manager may not have discretion to negotiate arrangements with prime brokers and other trading arrangements. The investor may be involved in negotiating these arrangements and may demand that a certain prime broker or other counterparty is used.

Alternative Form

Given the current economic climate and the issues that both investors and investment managers are confronting, an SMA offers an alternative investment form for which both investors and investment managers are showing increasing willingness and demand. Investors and investment managers should familiarize themselves with the potential structures of an SMA and commonly negotiated terms. ■

Carried Interest Proposed Legislation

DAVID W. MAYO AND LEE J. HEPNER

In his fiscal year 2010 budget proposal, President Obama called for the taxation of carried interests in investment funds as ordinary income starting in 2011. In addition, two pending pieces of legislation in New York could substantially increase the taxes payable on carried interests held by certain New York State managers. The first, Governor David A. Paterson's Executive Budget Bill, would impose New York's nonresident personal income tax on income from carried interest received for performing investment management services in New York State. The other, a bill introduced by Assemblyman Micah Kellner, would subject certain carried interest received in connection with investment management services to the New York City Unincorporated Business Tax ("UBT"). If enacted, both New York bills would take effect as of January 1, 2009.

Federal Income Tax

Under current law, the receipt of a partnership carried interest in exchange for services is generally not a taxable event for U.S. federal income tax purposes. Rather, the recipient of the carried interest recognizes income and gain with respect to such interest only when he or she receives proportionate allocations of partnership income and gain. The character of any income and gain in the hands of a partnership is retained when allocated to its partners. Therefore, dividends and long-term capital gains realized by the partnership, for example, are taxed to the holder of a carried interest at the current federal rates for dividends and long-term capital gains, and not as ordinary income.

President Obama's budget proposal, submitted to Congress on February 26, 2009, contains a single line item that calls for the taxation of carried interest as ordinary income. While the proposal indicates that this change would take place in 2011, it provides no details as to how ordinary income treatment would be achieved. The legislation resulting from this proposal could, among other things, treat all carried interest allocations as ordinary income notwithstanding the underlying character of the income or gain (which was the approach taken in legislation considered in the House of Representatives in the past two years), or it could take a different approach, such as taxing the initial grant of a carried interest. To best determine whether adjustments to investment fund structures may be required to deal with this change in taxation, we will continue to monitor any further legislative developments with respect to the President's proposal.

New York State Nonresident Income Tax

Under current law, a nonresident of New York State is subject to New York State income tax on the nonresident's New York source income. Thus, under current law, a nonresident partner in an entity that manages an investment fund is subject to New York State personal income tax on his share of management fee income arising out of management services performed in New York. The nonresident partner's share of the carried interest allocations made to the general partner, however, is not taxed as New York source income. That income, generally consisting of interest, dividends, and capital gains, is not earned in connection with a New York trade or business, and is not considered New York source income. Therefore, it is not taxable in New York to nonresidents.

> *The President's budget proposal, submitted to Congress on February 26, 2009, contains a single line item that calls for the taxation of carried interest as ordinary income.*

Governor Paterson's proposal would amend the New York Tax Law to require nonresident partners to include in their New York source income any income, gain, loss, and deduction attributable to "investment management services performed in exchange for consideration to a partnership or other entity." As a result, income attributable to carried interests, in addition to management fees, may be taxable to nonresidents providing investment management services in New York. Governor Paterson's proposal defines "investment management services" as: advising a business as to the value of any property; advising a business as to the advisability of investing in, purchasing, or selling any property; managing, acquiring, or disposing of any property; arranging financing with respect to acquiring property; and related support services. For this purpose, "property" includes stock, debt, derivatives, commodities, and real estate.

There is some uncertainty concerning the application of this proposal to a typical investment fund structure. Many investment funds, particularly in New York City, are currently structured in such a way that one entity acts as the investment manager and receives management fees, while the carried interest is actually allocated to the fund's general partner. Since the carried interest is not received by the entity providing investment management services, it is possible that for funds with this structure, carried interest allocations to nonresident managers will remain non-New York source income and therefore exempt from New York State income tax.

New York City Unincorporated Business Tax

The New York City UBT is a 4% tax imposed on the business income of every unincorporated business conducted, in whole or in part, in New York City. The UBT is currently imposed on management fees earned by fund managers. Income and gains generated from buying and selling property for one's own account are exempt from the tax because such activity does not constitute an unincorporated business. The character of the income and gains arising out of an unincorporated entity's self-trading is retained when allocated to partners of the entity. This is true regardless of how the interest in the unincorporated entity was acquired and regardless of whether the distributive share is proportionate to a partner's capital interest in the entity. Thus, carried interest in an investment fund is generally exempt from the UBT.

Assemblyman Kellner's bill would modify the trading exception by providing that any income or gain realized in connection with an "investment management services interest,"other than any portion of the interest received as a result of a capital contribution, will not be eligible for the trading exemption if held by an unincorporated business whose assets exceed $10 million. In general, carried interest in an investment fund constitutes an "investment management services interest," which the Budget Bill defines as "any interest in a business which is held by any person if such person provides, directly or indirectly, in the active conduct of a trade or business, a substantial quantity of any of" certain financial management services, which are substantially the same as those enumerated in the Budget Bill. ■

Management Profits Interests:

To Waive or Not to Waive in Light of Recently Proposed Tax Legislation

ROBERT M. HIRSH AND STEPHANIE R. MCCAVITT

Under President Obama"s fiscal year 2010 budget proposal, carried interest would be taxed as ordinary income beginning in 2011. No statutory language has yet been released, but based on statutory language proposed in 2007 and 2008 that may be used as a model for the administration's proposal, net income allocated to a fund's general partner or any of its affiliates with respect to what has been referred to under certain of such proposals as an "investment services partnership interest" would generally be taxed at ordinary income tax rates, even if such net income is an allocation of a share of long-term capital gains that would otherwise be taxed at the lower capital gains rates. An "investment services partnership interest" includes any interest in a partnership that is held by any person who provides (directly or indirectly) a substantial quantity of investment advisory and/or management services to the partnership. The proposals generally contained an exception for capital interests acquired upon the contribution of invested capital, which would not include any type of loan made to a partner, directly or indirectly, by any other partner or by the partnership.

It is expected that any carried interest legislation would also tax income from management fee waiver programs, also known as "management profits interests." A management profits interest is an indirect profits interest in a private equity fund that members of the investment management team receive in connection with a waiver of current management fees. The limited partners of the private equity fund contribute amounts equal to the waived management fees to fund what are in effect capital contributions to private equity fund investments on a pre-tax basis (i.e., notional capital contributions) on behalf of the management team. Upon realization of an investment, the management team generally will receive an amount equal to its notional capital contributions in such investment and proportionate profits thereon, in each case, only to the extent that the fund has available profits realized on the investment. Under the current tax law, it is intended that the return of these notional capital contributions and profits be converted into capital gains (assuming that the private equity fund earns capital gains). Management fee waiver programs are viewed as an effective tool to defer taxation of management fees and effectively convert management fee income to capital gains.

Under the proposed legislation described above, all profits associated with a management profits interest would be taxable at the higher ordinary income tax rates - both the notional capital contributions and the long term profits thereon. Accordingly, although the waiver may still defer taxes, it would not have the effect of converting management fee income to capital gains under such a proposal. On the other hand, if the management team receives the management fee income currently, pays ordinary income tax on such income, and invests those after-tax dollars (plus any required additional capital to fund their capital obligation to the private equity fund), profits earned on this cash investment would remain eligible for long-term capital gains treatment. Accordingly, the new tax proposal, if enacted, would significantly impact the overall analysis of whether it makes sense in existing private equity funds to continue to utilize management fee waiver programs, as the possibility of a higher effective tax rate must be added to the analysis of the other features of the management fee waiver program (tax deferral, the ability in effect to satisfy a capital commitment with pre-tax dollars (which reduces economic exposure to the private equity fund) and the need for the private equity fund to earn profits). Since decisions with respect to the utilization of these programs in existing private equity funds (including the application of waived management fees to new investments) may be made currently, it would be timely for management teams to begin the overall analysis now.

If you are interested in receiving numerical examples that illustrate the economic result of making an election versus not making an election under the current tax proposals, please contact Stephanie R. McCavitt at 212-373-3558. ■

Recent Litigation Affecting Private Funds

Distributions in Kind

Schuss v. Penfield Partners.

On February 4, 2009, the Delaware Chancery Court confirmed a fund sponsor's ability to override Section 17-605 of DRULPA in the fund partnership agreement. Under Section 17-605, unless otherwise provided for in a partnership agreement, a partnership may compel a partner to accept an in-kind distribution, but with respect to each of the fund's assets, not in an amount exceeding such partner's pro rata share in the capital of the partnership. In order to override Section 17-605, the language in the partnership agreement that would permit the fund to distribute more than a limited partner's partnership percentage of any fund asset must be sufficiently explicit.

Side Letters

Umbach v. Carrington Inv. Partners.

On February 18, 2009, the U.S. District Court for the District of Connecticut declined to dismiss claims by an investor relating to a side letter purporting to waive any lock-up of the investor's capital. In denying defendants' motion to dismiss, the Court rejected the defendants' arguments based upon "merger clauses" contained in the partnership agreement, providing that: "[T]he alleged misrepresentations relate to the Side Letter and its effect on Plaintiff's ability to withdraw his investment . . . These cannot be disclaimed by the integration clauses in the [Partnership] Agreement and Subscription Agreement, because the Side Letter was ambiguous and controlled the Agreement between the Plaintiff and Defendants.' The decision leaves in question to what extent a court may admit evidence of oral agreements to interpret the terms of a side letter where an investor claims that it was misled by a fund manager. The decision also highlights the importance of including a merger clause in a side letter agreement rather than relying on a partnership agreement or subscription agreement merger clause. ■

Handling Mass Redemptions

JENNIFER A. SPIEGEL

As the hedge fund industry grapples with an unprecedented volume of redemption requests, hedge fund sponsors are struggling to satisfy these requests while still complying with their fund documents and fiduciary duties, and preserve enough of their assets and investor capital to remain a viable presence in the industry. Below we note some issues that have arisen with respect to hedge fund redemptions. (Readers should be aware that this is a succinct summary of an article that Bloomberg Law Reports™ will be publishing in the near future.)

Gates and Suspensions

Gates and suspension provisions are two standard features of a hedge fund that enable the investment manager to preserve the value of the fund and prevent a sudden exodus of capital when faced with mass redemptions. A gate enables the fund to limit redemptions as of any date, while a suspension provision precludes redemptions altogether as of such date. Each plays a different role in a fund's strategy with respect to handling redemptions and the exact language of their drafting can lead to very different consequences.

Payments in Kind (PIKs) and Special Purpose Vehicles (SPVs)

Many funds have the ability to satisfy a redemption through a PIK - distributing an investment held by the fund to the investor. However, there are many practical obstacles a fund faces when making a PIK, as well as potential obstacles posed by Delaware's Revised Uniform Limited Partnership Act and some thorny fiduciary duty considerations. The exact partnership agreement language with respect to PIKs will be critical in defining the full extent of a fund's flexibility to make PIKs.

One form of PIK that was widely implemented during the period of 2008 year-end redemptions was a PIK made through a newly organized SPV. An SPV may be used to isolate and manage down assets to be liquidated in connection with satisfying redemptions of redeeming investors. The redeeming investors then receive a PIK in the form of an interest in the SPV in satisfaction of their redemption requests. Although an attractive mechanism that may enable a fund to avoid a fire sale of assets, many fund sponsors discovered that there are numerous potential pitfalls associated with such SPVs, ranging from compliance with fund redemption provisions, fiduciary issues, conflicts of interest and valuation issues. Some of these issues have been the subject of litigation in the United States and Bermuda.

Impact of Recent Redemptions on Hedge Fund Terms

As a result of the recent wave of redemptions, fund sponsors are keenly aware of the importance of matching the redemption terms of their fund documents to the liquidity of the assets held by the fund. Many have also had occasion to revisit and clarify partnership agreement provisions affecting redemptions, which may have been either ambiguous or did not provide the full range of flexibility that the fund sponsor would have liked.

Although every fund sponsor undoubtedly hopes that it will never again have to face such a period of volatility and massive redemptions, investors can expect that fund sponsors that survive this crisis will fine-tune their fund documents to incorporate features enabling them to handle mass redemptions without being forced to liquidate assets at depressed prices. These features may include explicit provisions in the partnership agreement to use SPVs, as well as individual investor-level gates. An investor that is subject only to an individual investor-level gate will not have its own liquidity dependent to the same extent on other investors' redemptions and thus may not be motivated to submit a redemption request solely to secure its place in the redemption line. However, these investor-level gates can obviously limit the ability of an investor to withdraw a large percentage of its capital at any one time and will necessarily impact an investor's liquidity management and initial decision to invest.

Because many investors have been uncomfortable having their liquidity rights affected so dramatically by the redemption decisions of other investors, investors will likely continue to show a growing interest in "separately managed accounts."

Please see *"Separately Managed Accounts"* by Marco V. Masotti and Jyoti Sharma on page 1. ■

SEC Speaks: Custodial Controls a Priority

During the recent "SEC Speaks" conference in Washington, D.C., Associate Director Gene Gohlke of the SEC's Office of Compliance, Inspections and Examinations (OCIE) noted that custody and safety of client assets will be a special focus of the SEC during 2009 and 2010 examinations. Examiners will focus on advisers' compliance and operating procedures with respect to custody, which he said should be designed to ensure that client assets are protected from theft and misuse. Among other things, examiners will be selecting a sample of the examined firm's clients and contacting them directly to verify their advisory account balances - a practice that some advisers are concerned could create reputational issues for them unless the SEC makes clear to such investors that the request is a routine request and signals no potential wrongdoing by the adviser. Last week, the SEC advised that "these account confirmation requests should not be considered as an indication by the Commission or its staff that any violations of law have occurred, nor should these requests be construed as an adverse reflection upon the adviser or any person or entity associated with a firm." ■

ELECTRONIC FORM D FILING MANDATORY AS OF MARCH 16

As a reminder, as of March 16, 2009, Form Ds must be filed electronically through the SEC's EDGAR system. All funds must have a Central Index Key (CIK) number and CIK Confirmation Code (CCC) in order to file electronically. Please see our February 18, 2009 client alert entitled *"Electronic Form D Filing Mandatory as of March 16"* for further information on this topic. ■

Defaulting Limited Partners

ROBERT M. HIRSH, MITCHELL L. BERG AND JILL M. SILVERMAN

Prolonged troubles in the economy have increased the potential for limited partner defaults in private equity funds. Most fund sponsors are already aware of the more obvious issues related to defaults, including the general partner's fiduciary duties in connection with its exercise of remedies, the enforceability of remedies in different jurisdictions, and the potential for regulatory problems that arise as the total size of a fund changes and the percentage interest of some limited partners increases. This article addresses three more subtle issues that have not previously been fully explored relating to a very common private equity fund default remedy - the general partner's ability to reduce a defaulting limited partner's capital account and share the forfeited portion with non-defaulting limited partners.

Effect on Other Limited Partners of General Partner Discretion

As defaults grow more common, all limited partners are paying more attention to the potential remedies that a general partner has under the partnership agreement. Non-defaulting limited partners in particular are becoming increasingly aware that they could benefit from the general partner's exercise of some of these remedies. For example, if a limited partner defaults, the general partner may cause it to forfeit as much as 50% of its capital account balance, with the non-defaulting limited partners succeeding to the forfeited portion. This can be quite a windfall for a non-defaulting limited partner when a large institutional partner defaults.

In some cases, limited partners have even written to a general partner to "remind" the general partner of their expectation that the general partner will strictly enforce its remedies against defaulting limited partners, including by imposing a capital account forfeiture and shift. Historically, general partners may have shied away from exercising the full extent of their rights against a defaulting limited partner in order to preserve an existing relationship with the defaulting partner. However, now that limited partners are aware that they can potentially benefit from the default of another partner, they may pressure general partners to exercise the full extent of their discretion under the default provisions of the partnership agreement.

Most partnership agreement default provisions afford the general partner very broad discretion over which remedies, if any, are exercised. Thus, while the increased pressure on a general partner to exercise remedies might at first appear to limit a general partner's freedom, it may in fact enable them to exercise their discretion more liberally. This is because general partners that might otherwise have been lenient on a defaulting partner in order to maintain a good relationship will now have a justification for much stricter treatment - the other limited partners are watching and holding them accountable. This enables general partners to enforce the default remedies under the partnership agreement, including by reducing a limited partner's capital account, without being seen as unnecessarily punitive.

Calling Temporary Cash Funds

Limited partners that are invested in numerous private equity funds, but that suddenly face a diminished supply of available capital, may strategize over which funds' capital calls they will default on and which they will honor. Obviously, where a partner has funded the majority of its commitment to the fund, the threat of losing half of its capital account will probably be significant enough to discourage the limited partner from deliberately defaulting in that fund. However, where a general partner has not yet called any capital, or where the capital accounts are minimal, the prospect of a capital account forfeiture may not be especially ominous for limited partners. As a result, one way to deter defaults might be for the general partner to call a certain amount of capital in advance to be held as "Temporary Cash." Many partnership agreements contain provisions permitting such calls to be made without reference to a specific investment, but rather to be held in reserve and used if and when the general partner identifies an investment. Because capital called as Temporary Cash would increase a limited partner's capital account by the called amount, the potential loss for a limited partner who later defaults is that much greater. An added benefit of this approach is that it can enable a general partner to anticipate a default by a specific limited partner prior to calling capital for an investment. For example, if a general partner makes a call for Temporary Cash and a partner defaults, it is likely that that same partner will also default on a call for an investment. This initial default puts the general partner on notice that the fund may need to secure additional capital in order to be able to complete an anticipated investment.

Aggregation of Partnerships and AIVs with Respect to Default Remedies

General partners sometimes establish alternative investment vehicles (commonly known as "AIVs") for investments that could create adverse tax consequences for certain limited partners and/or the general partner if they were made directly by the main fund. Many of these arrangements, drafted before the heightened sensitivity to defaults, do not aggregate the AIV and the main fund for purposes of imposing default remedies. Thus, a default by a limited partner on a capital call to an AIV would lead only to a reduction in its capital account in the AIV, and not a reduction in its capital account in the main fund. Consider, however, a situation where some limited partners have invested in all investments through the partnership, but others hold half of their investments through the partnership, and half through the AIV. If a limited partner with investments in the AIV defaults on a capital call by the partnership, the general partner could then reduce such limited partner's capital account in the partnership, but would have no ability to reduce such limited partner's capital account in the AIV. Despite the AIV having been put in place for tax and not other reasons, a defaulting limited partner with all of its investments held through the partnership will forfeit more of its capital than a defaulting limited partner who invests primarily through the AIV, even when the economic magnitude of the default is exactly the same for both limited partners - an odd result. The equitable fix would be to cross default the interests in the AIV with the interests in the main fund; however, before introducing a cross default, one must consider several issues, including the tax effect of such aggregation, the potentially different results under the law governing the main fund and the law governing the AIV and, finally, how the benefit of a capital account forfeiture is shared among limited partners of the main fund and the AIV. ■

General Partner Facilitation of Sales of Limited Partner Interests

JENNIFER A. SPIEGEL

Given the volume of potential limited partner defaults this year, general partners are understandably very keen to help their limited partners in any way possible to avoid a default through a secondary sale of the limited partner interests. However, a general partner needs to consider a number of factors when facilitating sales of limited partner interests, including whether it is acting as a broker. This concern is in addition to all of the other concerns that any secondary transfer raises (publicly traded partnership issues, fiduciary issues, eligibility of the transferee, Investment Company Act issues, Investment Advisers Act issues (has the transferee become a "client"?), confidentiality, etc).

Although there is no bright line guidance for when a general partner's role in a secondary purchase amounts to "effecting transactions in the securities for the account of others" and subjects the general partner to potential regulation as a broker-dealer under the Securities Exchange Act of 1934, set forth below are some general preliminary guidelines general partners should consider when facilitating transfers of limited partner interests.

This is preliminary guidance only, and each of these factors will need to be assessed in light of its degree and frequency. A general partner should seek the advice of counsel before taking it upon itself to track down buyers for the fund interests of limited partners that it fears may default.

High Risk General Partner Activities

- **Receiving Compensation in Connection with a Sale.** If the general partner receives any form of compensation in connection with the sale of a limited partner interest, this could be a "bad fact" in analyzing the general partner's activities in the context of potential broker-dealer regulation. General partners should note that compensation may take subtle forms, such as the release of unrelated claims or an overly broad indemnification of the general partner (including with respect to claims unrelated to the transfer).
- **Advertising the Sale of Limited Partner Interests.** A general partner could be considered to be holding itself out as a broker if it facilitates sales by announcing that limited partner interests are available for sale, even if it limits this announcement to pre-screened accredited and otherwise qualified transferees.
- **Participating in the Sale Discussion.** If the general partner takes the lead in structuring or negotiating the business terms of the transfer, including, especially, the price (which could arise subtly when the general partner is asked to weigh in on what constitutes "market terms" for sales of interests in today's market), it may be effecting transactions in the securities of others.
- **Soliciting Potential Purchasers.** A general partner should be careful that whether through advertising or otherwise, it is not actively soliciting potential transferees or purchasers for the sale of a limited partner interest.

Low Risk General Partner Activities

- **Reviewing Transferee Eligibility.** A general partner's due diligence review regarding the transferee to ascertain such transferee's compliance with investor eligibility is a necessary function in connection with any fund's compliance and should not in and of itself raise broker-dealer concerns.
- **Providing Fund Information.** Prospective transferees will obviously want to diligence limited partner interests as thoroughly as possible. The provision by the general partner of recent quarterly reports and a private placement memorandum (with appropriate disclaimers) to prospective transferees should also be an acceptable activity. Note that the prospective transferee should be subject to a confidentiality agreement and the general partner should be careful about providing any information that has not already been provided to (or that is being shared simultaneously with) existing limited partners.
- **Putting Seller and Buyer in Touch.** Passively putting in contact (i) a selling limited partner who has, on its own initiative, contacted the general partner and (ii) an interested buyer who has, on its own initiative, contacted the general partner expressing an interest in purchasing a limited partner interest should not raise issues. ■

Proposed Legislation Affecting Private Funds

Not long after SEC Chairman Mary Schapiro's Senate Confirmation Hearings, in which she called for immediate federal legislation to regulate hedge funds, several legislative proposals were introduced in Congress and at the State level. Below are summaries of some of those proposals. Although most of these proposals are intended to target hedge funds, as currently drafted, many would apply to all types of private funds, including private equity funds.

- *Hedge Fund Transparency Act.* Senators Chuck Grassley and Carl Levin have introduced legislation entitled the "Hedge Fund Transparency Act of 2009" which provides that funds that satisfy the requirements of Section 3(c)(1) or 3(c)(7) of the Investment Company Act and that have assets, or assets under management, of $50 million or more, may only remain exempt from regulation as an investment company if the fund: (i) registers with the SEC; (ii) files an annual disclosure form with the SEC; (iii) maintains such books and records as the SEC may require; (iv) cooperates with SEC requests for information or examination; and (v) establishes an anti-money laundering program and reports suspicious transactions. Please see our January 30, 2009 client alert entitled *"Senate Bill Would Require Private Funds to Register and Make Disclosures"* for further information on this topic.
- *Hedge Fund Adviser Registration Act of 2009.* Representatives Michael Capuano and Michael Castle have introduced legislation entitled the "Hedge Fund Adviser Registration Act of 2009" which deletes the "private adviser" exemption from Section 203(b)(3) of the Advisers Act. As a result, most currently exempt private fund advisers with over $25 million in assets under management would be required to register with the SEC as investment advisers, making them subject to all of the provisions of the Advisers Act. *(continued on page 8)*

Implications of FAS 157 "Fair Value" Accounting on Private Funds

STEPHANIE R. MCCAVITT AND JENNIFER A. SPIEGEL

Beginning last year, for the first time, private funds were faced with implementing a methodology to comply with the requirement to "fair value" their investments pursuant to Financial Accounting Standards Board Statement 157 ("FAS 157"), which became effective for fiscal years beginning after November 15, 2007. The difficulty in assigning fair values to hard-to-value assets, which historically have been valued at cost, is further exacerbated by the current credit crisis and resulting global market disruptions. This mark-to-market requirement raises various concerns for both private equity funds and hedge funds.

Overview of FAS 157

In general, FAS 157 provides guidelines that prioritize the type of data required to be used to mark-to-market investments under U.S. Generally Accepted Accounting Principles ("GAAP") and requires detailed financial statement disclosure concerning such valuation. Under the guidelines, investments must be valued using the price that would be received in the market to sell the investment based on market data (observable inputs). Only if there is little, or no, market activity, or when relevant market data is unavailable, is management allowed to rely on its own assumptions (unobservable inputs). FAS 157 introduces a hierarchy of three levels of inputs, with observable inputs or quoted prices for identical assets being the preferred source of valuation. Because this approach to fair value measurement assumes orderly transactions between market participants, it will be difficult to apply in times of market disruption where transactions are often distressed or forced. The SEC and the FASB have acknowledged that the determination of fair value will require challenging judgment calls during this period of market uncertainty; however, requests to postpone its application were rejected.

What Does This Mean for Private Funds?

The requirement to mark-to-market illiquid investments raises various issues, particularly in the midst of the current credit crisis when comparable investments and observable inputs are likely unavailable. The following are some issues private funds may be grappling with:

Market Comparables vs Discounted Cash Flow ("DCF")

Private equity funds and hedge funds that hold non-public investments, which has become increasingly common in recent years, will undoubtedly have difficulty identifying comparable investments in the current market. Securities of a public company that operates in the same market sector as a privately-held portfolio company may have suffered a significant decline in value in the current turbulent stock market, which may not be indicative of the value that should be attributable to the private investment. Thus, a private fund sponsor must first decide whether it should consider the value of public companies in valuing its own private investments. Other observable inputs may not be available to begin with due to the lack of comparable private transactions in the current stagnant marketplace. As a result, fund sponsors may use less favored valuation approaches, such as a DCF approach. Reliance on DCF, which emphasizes a company's potential for long-term cash flow when analyzing its value, could enable a fund sponsor to avoid reflecting large losses associated with the sudden decrease in asset values since September 2008. DCF can also help avoid the "choppy" results that many have feared a mark-to-market approach would introduce to otherwise smooth private equity returns. Nonetheless, whether a comparables or DCF approach is used, a fund sponsor must take care to include appropriate disclosure regarding the particular approach it implements to fair value the fund's assets.

One Investment, Multiple Valuations

Investments may be valued very differently by different fund sponsors as one fund sponsor may consider a public comparable in valuing while another fund sponsor determines no comparable exists. For an institutional investor holding the same investment through different fund sponsors, this means it could have multiple valuations for the same investment in its portfolio. The existence of multiple valuations can undermine investor confidence, which is already in short supply.

Unrealized Losses

Many private equity funds take unrealized losses into account when distributing proceeds of an investment to investors only *(continued on page 9)*

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Pension Security Act of 2009.
Representative Castle has introduced legislation entitled the "Pension Security Act of 2009" that would amend Title I of ERISA to require disclosure of plan investments in hedge funds in the annual report of each defined benefit pension plan. The disclosure would specifically include a schedule identifying each hedge fund in which the plan invests as of the end of the plan year covered by the annual report and the amount invested in each fund.

Hedge Fund Study Act.
Representative Castle has introduced legislation entitled the "Hedge Fund Study Act" that would require the President's Working Group on Financial Markets to conduct a study on the hedge fund industry. The report is to include recommendations with respect to (i) legislation relating to appropriate disclosure requirements for hedge funds; (ii) the type of information hedge funds should disclose to regulators and to the public; (iii) efforts the hedge fund industry or regulators of financial institutions should undertake to improve practices; and (iv) oversight responsibilities that members of the Working Group should have over the hedge fund industry, and the degree and scope of such oversight.

Stop Tax Haven Abuse Act.
Senator Levin has introduced the "Stop Tax Haven Abuse Act" which is intended to stop offshore tax haven and tax shelter abuses, and that would, if enacted, change substantially the tax treatment of non-U.S. hedge funds and likely other non-U.S. corporations that are managed in the United States. A companion bill was introduced in the U.S. House of Representatives by over 40 Members led by Representatives Lloyd Doggett and Rosa DeLauro. The Stop Tax Haven Abuse Act is an improved version of legislation introduced in the last Congress. The bill has been strengthened with the addition of three new provisions that would: (i) treat foreign corporations managed and controlled in the United States as domestic corporations for income tax purposes; (ii) change the U.S. withholding tax treatment of equity swap *(continued on page 9)*

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if the unrealized losses represent a significant and permanent decline in value. Some private equity funds, however, define the concept of unrealized loss based on GAAP. Depending on the relevant definitions used in the partnership agreement's distribution provisions, fair value accounting may require those funds to take into account unrealized losses that previously would not have affected distributions of investment proceeds. This in turn can affect the fund's "IRR" calculation and delay the receipt of carried interest distributions by the fund sponsor.

Similarly, hedge funds with "side pocketed" illiquid investments typically take only realized losses into account when striking a fund-wide net asset value for purposes of calculating the management fee and annual incentive allocations. Taking unrealized losses into consideration could decrease fee and incentive income unless the fund sponsor is comfortable with "NAV Divergence." See "NAV Divergence" below.

Defaults

Private equity fund investors with limited capital resources available given current market conditions may make calculated decisions as to which of their investments to default on based on valuations reported. Prior to the implementation of FAS 157, this information would not have been available to these investors. Default considerations may place an additional strain on a firm's valuation methodology.

Secondary Sales

The decision to buy or to sell a fund interest in the secondary market will also be made based on investment value information. Therefore, the approach taken to value investments and the values assigned to those investments will affect not only decisions made by a fund's current investors - whether to redeem or sell in the secondary market - but will also affect the decisions of potential secondary market purchasers. This valuation issue could add additional complexity to the secondary market which is growing rapidly to address existing investors' needs for immediate liquidity.

Investment Allocations

Institutional investors, such as pension funds and funds of funds, will now base their own investment allocations (for current and future years) in part on valuations received from their fund investments. Therefore, mark-to-market valuations will likely affect certain investors' own investment allocations, as well as what they report on their financial statements to their investors.

Performance; Fundraising

A fund sponsor raising a new fund must decide whether to report its performance based on its GAAP-based financial statements or based on an alternative set of financial statements that do not contain mark-to-market valuations, but that disclose such value differences. During stable markets, GAAP-based financial statements could have the effect of arguably overstating the value of investments that have not been sold, while in the current market they will potentially understate such values, resulting in additional "paper losses" which could unsettle an already anxious investor base. It may be difficult to determine which approach provides the most appropriate picture of the performance of a fund's investments.

Disclosure; Operative Documents

Fund sponsors must disclose in their financials which category of "input" they relied upon to value their assets. They may also consider including disclosure in their offering documents regarding their implementation of FAS 157. In addition, fund sponsors may consider including provisions in their operative fund documents that set forth the framework they intend to use for their valuation methodology and include an investor acknowledgement as to such procedures.

NAV Divergence

Some funds, hedge funds in particular, have already implemented what accountants refer to as "NAV divergence" - the use of one value for purposes of subscriptions, redemptions and management fee and incentive allocation calculations and the use of another value, an FAS-compliant value, for purposes of financial statements and creation of reserves. Although this practice pre-dates the arrival of FAS 157, it may come under stricter scrutiny as fund sponsors and investors struggle to grasp the full effects of FAS 157.

Investment Advisers Act

Rule 206(4)-(8) of the Investment Advisers Act of 1940 prohibits investment advisers from making false or misleading statements to investors and prospective investors in private funds. Distributing misleading financial statements could fall within this rule. Because the rule also applies to misleading "conduct", a fee calculation - without any corresponding statement - based on an improper valuation could also be caught by the rule. Importantly, the rule does not require any specific intent or knowledge of the improper valuation. As a result, a fund sponsor relying on valuations provided in the *(continued on page 10)*

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payments that are a substitute for dividends on stocks of U.S. issuers; and (iii) expand the tax return reporting requirements for passive foreign investment corporations (PFICs) to include U.S. persons who don't own a PFIC, but have formed, sent assets to, received assets from, or benefited from a PFIC.

Please see our March 5, 2009 client alert entitled *"Levin Bill Would Change Taxation of Non-U.S. Hedge Funds and Other Non-U.S. Corporations"* for further information on this topic.

Proposed Bill to Detect, Deter, Discourage Offshore Tax Evasion.

As an alternative to Senator Levin's bill, Senate Finance Committee Chairman Max Baucus is currently circulating a "very preliminary draft" of legislation intended to enhance the transparency of offshore activity and to give the IRS better tools to deter, detect and discourage offshore abuses and noncompliance. The draft focuses on compliance, primarily through information reporting, extending certain statutes of limitations and fines/penalties. In summary, the proposal: (i) requires entities transferring funds offshore (other than on behalf of publicly traded companies) to report to the IRS the amount and destination/account information of the funds transferred; (ii) extends the statute of limitations from three to six years for tax returns reporting, or that should have reported, certain international transactions, to give the IRS more time to detect and examine offshore activity; (iii) requires the Foreign Bank Account Reports (FBAR) form to be filed with the income tax return, turning the FBAR into tax return information and making it easier for the IRS to enforce FBAR filing requirements; (iv) requires preparers to ask a series of due diligence questions to determine whether an FBAR should be filed; (v) enhances the penalty for a foreign trust's failure to file, particularly when the corpus of the trust is unknown, by establishing a $10,000 minimum penalty; (vi) with respect to transfers from foreign trusts, expands the types of property considered to be a distribution (e.g., artwork and jewelry); (vii) doubles applicable fines and penalties on underpayments attributable to certain offshore transactions; and (viii) modifies a provision in the 2008 Heroes Act that requires offshore entities that hire workers to perform services pursuant to a government contract to be treated as American employers by establishing a rule that at least 100 hours of service a month constitutes an employee. The Senate Finance Committee staff is currently requesting comments on the draft proposal.

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financials of its portfolio companies could run afoul of the rule if those valuations are incorrect. Fund sponsors should be mindful of this risk when working with portfolio companies, auditors and valuation experts to establish their valuation techniques, methodologies and policies.

As FAS 157 begins to be implemented by private funds this year, we expect that additional issues and concerns will arise, which will be fueled by the difficulties in applying the guidelines in practice as well as ever-changing market conditions.

FASB Proposes Additional Guidance

FASB recently announced two proposals relating to FAS 157 intended to address issues associated with (i) measuring the fair value of securities in markets that have become inactive and may reflect distressed transactions and (ii) reflecting impairment of value in the current economic crisis. The comment period for these proposals ends on April 1, 2009. ■

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Connecticut Hedge Fund Legislation. Connecticut lawmakers recently introduced three bills that would bring significant changes to CT's long-standing hands-off approach to regulating hedge funds. The bills would apply to any hedge fund that has an office in CT where employees regularly conduct business on behalf of a hedge fund. Specifically, Senate Bill 953 provides that: (i) starting in 2011, hedge funds may not have individual investors who have less than $2.5 million in investment assets or institutional investors who have less than $5 million in assets; (ii) hedge fund managers must disclose certain conflicts of interest to investors and prospective investors; (iii) hedge fund managers must disclose to each investor (a) any material change in its investment strategy and the departure of any employee who exercises significant control over the investment strategy, (b) the existence of any side letters, and (c) any major litigation involving the fund or governmental investigation of the fund; and (iv) starting in 2010, hedge fund managers must disclose, in writing, to each investor the fee schedule to be paid by the hedge fund and a financial statement that has been audited by an independent accounting firm. The CT Joint Committee on Banks approved Senate Bill 953; however, the bill has not been moved to full Senate consideration. Senate Bills 6477 and 6480 provide, respectively, that hedge fund managers and "private capital fund" managers would be required to be licensed to conduct business in CT, and that hedge funds and "private capital funds" with CT pension fund investors would also be required to disclose detailed portfolio information to such pension funds upon request. At this time, the CT Joint Committee on Banks has not taken any further action regarding Bills 6477 and 6480. During a hearing on the proposed legislation conducted by the Banks Committee of the CT General Assembly, Banks Committee Chairman, Senator Robert Duff and CT Attorney General Blumenthal stated that Federal regulation of hedge funds was preferable, but they feel that state regulation will be necessary to fill the regulatory void in the absence of Federal action. ■

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