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Focus

Summer 2004

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Paul, Weiss Investment Funds Group
The Investment Funds Group is a dedicated asset management practice that focuses on a wide variety of private and public investment funds. The Group participates in the organization, fund raising and maintenance of private investment funds of every type, including buyout funds, venture capital funds, distressed funds, mezzanine funds, sponsorship funds, infrastructure funds, co-investment funds, funds of funds and hedge funds. The Group is involved in organizing, registering, acquiring, merging, liquidating and advising both open-end and closed-end investment companies registered under the Investment Company Act of 1940. Additionally, the Group represents a diverse group of domestic and foreign investors in connection with their investments in investment funds.

On September 22, 2004, **Marco Masotti** will speak on "What GPs Need to Know about Due Diligence" at the 2004 Private Equity Analyst Conference in New York.

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Editors: Marco V. Masotti and Chris Jochnick

Hedge Fund Advisers in the SEC Spotlight

Proposed Rule Does Not Apply to Private Equity Funds

Marco V. Masotti and David C. Miller

On July 20, 2004, the Securities and Exchange Commission (the "SEC") published for comment proposed Rule 203(b)(3)-2 (the "Rule") that would effectively require hedge fund advisers to register with the SEC under the Investment Advisers Act of 1940 (the "Advisers Act").

The Rule requires advisers to "private funds" to register with the SEC by requiring these advisers to "look through" their respective funds and count the number of investors in each (rather than counting each fund as a single client) when determining whether the advisers are eligible for the exemption under the Advisers Act for advisers with 14 or fewer clients. Defined by reference to the characteristics shared by most hedge funds in the marketplace, a "private fund" is one that: (i) would be an investment company but for the exceptions in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940; (ii) permits owners to redeem their ownership interests in the fund (i.e., sell them back to the fund) within two years of purchase; and (iii) is offered based on the investment advisory skills, ability or expertise of the investment adviser. The two-year redemption test would apply to each investment in the fund.

Based on the two-year redemption feature, advisers to private investment funds requiring long-term commitments of capital (such as private equity and venture capital funds) would generally not be required to register. The Rule provides a limited exception for investors who redeem their interests within two years of purchase due to events that are found to be, after reasonable inquiry, "extraordinary and unforeseeable" at the time any such interests were issued (i.e., circumstances making it illegal or impractical for an investor to continue to own an interest in the fund). This exception is intended to address the special redemption rights that these funds typically allow for legal, regulatory or tax reasons (such as the redemption rights typically provided to ERISA, bank holding company and foundation investors). Nevertheless, despite its focus on hedge fund advisers, the SEC is seeking comment on whether the scope of the Rule should be extended to include advisers to private equity and venture capital funds.

The SEC believes that registration under the Rule would permit it to, among other things: (i) collect and provide to the public basic information about hedge funds and their advisers, including the number of hedge funds operating in the United States, the amount of assets under management, and the identity of their advisers; (ii) examine hedge fund advisers to identify compliance problems early and deter questionable practices; (iii) require all hedge fund advisers to adopt basic compliance controls to prevent violation of federal securities laws; (iv) improve disclosures made to prospective and current hedge fund investors; and (v) prevent felons or individuals with serious disciplinary records from managing hedge funds.

The SEC also proposed amendments to related rules under the Advisers Act, including the recordkeeping, performance fee and custody rules. In order to smooth the transition for hedge fund

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advisers, the recordkeeping rules allow new registrants to use performance information for periods prior to their registration despite lacking the supporting records otherwise required of registered advisers. Also, the performance fee rules permit new registrants to continue receiving incentive fees and allocations from investors who are not "qualified clients" (generally, investors with a net worth of $1.5 million or with at least $750,000 under the management of the adviser) so long as such investors invested prior to the adviser's registration. For the benefit of advisers to funds of hedge funds, the period in which audited financial statements must be distributed to investors under the custody rules is extended from 120 days to 180 days.

Significantly, the Rule contains special provisions for advisers located outside the United States. Offshore hedge fund advisers are required to register with the SEC if, looking through the funds they manage, whether or not those funds are also located offshore, they have more than 14 U.S. investors. The impact of registration is limited, however, because the Rule permits an offshore adviser to an offshore fund to treat the fund as its client (and not the investors) for all purposes under the Advisers Act, other than (i) determining the availability of the private adviser exemption, and (ii) those provisions prohibiting fraud. As a result, the substantive provisions of the Advisers Act, such as those relating to books and records, custody and cash solicitation fees, would not apply to registered offshore hedge fund advisers' dealings with their offshore funds and non-U.S. clients. The registration requirement for offshore hedge fund advisers may be one of the more controversial aspects of the Rule, and it will likely be the subject of further comments from a wide range of industry participants.

Other areas in which the SEC has expressed particular interest in receiving feedback from industry participants include: (i) the burdens registration would impose, and whether those burdens could be alleviated in some manner that also meets the SEC's stated objectives; (ii) the impact, if any, on hedge fund advisers' choice of management strategy and investments; (iii) whether an undue burden is placed on smaller advisory firms; (iv) the possibility of requiring offshore hedge fund advisers to look through their offshore funds only if assets attributable to U.S. residents comprise more than a threshold percentage; and (v) the reasonableness of the limit on extraterritorial application of the Advisers Act.

Comments on the Rule are required to be submitted to the SEC by September 15, 2004 with its possible adoption by the end of the year.

Distributions in Kind by Private Equity Funds

Some Important Considerations for Fund Managers

Robert M. Hirsh, John C. Kennedy and Jennifer N. Visconti

There may be significant business or tax reasons for a fund to make distributions in kind of securities to investors and, given the recent rebound of the capital markets, funds are making such distributions more frequently now than in the past. Generally, private equity funds are authorized to make distributions in kind of "marketable securities" prior to their dissolution. However, in doing so, fund managers must clear both regulatory and contractual hurdles which may affect, as a practical matter, the risks and obligations connected with such a distribution.

Importantly, funds must comply with the requirements of the securities laws with respect to any distribution of public securities. Although many commentators believe that a fund's distribution of public securities does not constitute a sale or acquisition for purposes of the short-swing profit disgorgement provisions of Section 16 of the Securities Exchange Act of 1934, this is an uncertain area due to a recent district court ruling. *Dreiling ex rel. InfoSpace, Inc. v. Kellett*, 281 F. Supp. 2d 1215 (W.D. Wash. 2003). The general partner should consult with counsel prior to a distribution to ensure that the fund will not be exposed to Section 16 liability.

If the general partner desires (or is required) to give prior notice of the distribution to investors, it should be aware that such notice could lead to "front running" by partners who wish to sell the securities short or enter into other hedging transactions, resulting in downward pressure on the price of the securities. The general partner should consider including a statement that the information in the notice is confidential and that no trading in the public securities (or any derivatives based on such securities or the value of such securities) should occur prior to the distribution.

If the fund has held the securities for more than two years, any partner (which is not an affiliate of the issuer after the distribution) may sell securities received immediately, without regard to volume or manner of sale limitations. However, affiliated partners must comply with the restrictions and requirements of Rule 144 of the Securities Act of 1933.

Unless the distribution is of such a significant amount that it could impact the liquidity of the public securities, a fund generally has no obligation to advise the market of its intention to make a distribution. However, the fund must make certain public filings after the distribution, such as amending its existing Schedule 13D (or Schedule 13G, if applicable) and filing a Form 4. Funds may disclose in their Schedule 13D or 13G filings that a distribution to partners is a possibility in order to avoid having to amend those filings prior to the distribution. Any partners with Schedule 13D, Schedule 13G or Form 3 and 4 filing obligations must also make filings with the SEC based on the percentage of outstanding shares that such partner will own as a result of the distribution.

Contractually, a fund must comply with all provisions in the fund's partnership agreement relating to in kind distributions. The partnership agreement typically will provide a mechanism for valuing securities, as well as notice provisions and other administrative requirements specifically relating to such distributions. Side letters also may impose requirements (or prohibitions) with respect to certain individual investors.

A Tax Victory for India Funds Based in Mauritius

A Helpful Ruling Clarifies the Terrain for Investment Funds in India

Mitchell L. Berg and Salil K. Gandhi

Private equity funds that intend to invest in India have frequently been formed in Mauritius, which offers favorable capital gains treatment through the operation of the India-Mauritius Convention for the Avoidance of Double Taxation (the "Tax Treaty"). In recent years, India tax authorities have cast doubt on the application of the Tax Treaty to funds which are resident in India but in which there is some extra-Mauritius involvement. However, on October 7, 2003, the Supreme Court of India issued an important decision reaffirming the eligibility of entities resident in Mauritius - as evidenced by a certificate of residence issued by the Mauritius authorities - to claim the benefit of the Tax Treaty. *Union of India v. Azadi Bachao Andolan and another*, Civil Appeal Nos. 8161-62 of 2003.

The Tax Treaty was initially entered into on April 1, 1983 for the "avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains and for encouragement of mutual trade and investment." Pursuant to the Tax Treaty, the Central Board of Direct Taxes (the "CBDT") of India issued Circular No. 882 dated March 30, 1994, stating that capital gains accrued by any resident of Mauritius by the transfer of shares of an Indian company are to be taxable only in Mauritius according to Mauritius taxation laws and will not be subject to tax in India. Mauritius currently does not impose any taxes on capital gains on its residents. Thus, under Circular No. 882, Mauritius entities that invest in Indian companies can exit their investments free of capital gains tax in both Mauritius and India.

However, in 2000, some Indian income tax authorities, concerned with what they perceived as abuse of the treaty, challenged the eligibility of certain foreign institutional investors for the benefits of the Treaty, claiming that their investments were being made by "shell companies" incorporated in Mauritius that were being controlled and managed outside of India or Mauritius. In response, the CBDT issued Circular No. 789 on April 13, 2000 that clarified that a certificate of residence issued by Mauritian authorities constituted sufficient evidence that an entity was resident in Mauritius and therefore eligible to claim the benefits of the Tax Treaty. Subsequently, two petitioners challenged Circular No. 789 before the Delhi High Court, which ultimately quashed the circular as being inconsistent with the provisions of the Indian Income Tax Act, 1961 (the "1961 Act"). In the Azadi Bachao Andolan case, the Supreme Court reversed the High Court judgment in full, finding that Circular No. 789 was properly enacted under the 1961 Act. In its discussion, the Supreme Court stated, among other things, that an entity which is properly resident in Mauritius will not be denied the benefits of the Tax Treaty because of the motives of its founders for incorporating in Mauritius.

Accordingly, sponsors seeking to invest in India through a Mauritius fund should establish corporate governance practices (including the designation of a sufficient number of Mauritius directors and the avoidance of an excessive degree of direct control of individuals residing outside Mauritius) to ensure receipt of a certificate of residence and should consult with both Mauritius and Indian counsel to ensure that they qualify for the benefits of the Tax Treaty.

Compliance Programs for Advisers

Registered investment advisers have until **October 5, 2004** to comply with Rule 206(4)-7 of the Advisers Act relating to compliance programs. The new rule requires registered advisers to adopt written compliance procedures (which must be reviewed annually) and to designate a chief compliance officer (the "Compliance Officer"). The Compliance Officer must have requisite knowledge of federal securities laws and the authority and seniority sufficient to compel employees' adherence to the compliance policies and procedures. The Director of the SEC's Office of Compliance, Inspections and Examinations, Lori Richards, recently stated that the SEC will view the Compliance Officer as an ally, along the lines of independent auditors and boards of directors, and noted that routine compliance monitoring by the Compliance Officer will not be protected by attorney-client privilege. Richards also cautioned against outsourcing the work of the Compliance Officer, underscoring that he or she must have intimate knowledge of the firm's operations in order to administer its compliance programs effectively.

Allowing Public Entities to Maintain Fund Confidentiality

Several states have recently amended their open record laws or Freedom of Information Act statutes as a means of balancing the interests of transparency in government with the confidentiality concerns of private equity funds. In many states, information received by state pension funds and public university endowments, including financial information and valuations, may be publicly disclosed. Michigan, Colorado and Virginia have recently amended these laws (and similar bills are pending in Massachusetts and Illinois) to restrict public access to such information. The Michigan amendment requires public universities to disclose the names of the funds in which they invest, the aggregate investment in such funds and the aggregate rate of return on such investments, but allows the universities to withhold most other confidential information. Similarly, the Colorado law prevents the release of underlying asset data (such as trade secrets and financial reports of portfolio companies), but permits disclosure of fund performance data.

Codes of Ethics for Advisers

The SEC has adopted Rule 204A-1 and related rule amendments under the Advisers Act that require registered investment advisers to adopt codes of ethics aimed at enhancing openness, integrity, honesty and trust. Advisers have until **January 7, 2005** to comply with the new rule. In the release accompanying the new rule, the Commission reasons that the rule "will benefit investment advisers by renewing their attention to their fiduciary and other legal obligations, and by increasing their vigilance against inappropriate behavior by employees Ö. The codes will impress upon advisers' supervised persons the significance of the fiduciary aspects of their professional responsibilities, formulating these into standards of conduct to which their employers will hold these individuals accountable." The codes of ethics must set forth standards of conduct based on the adviser's fiduciary obligations (the rule does not specify a particular standard) and must require compliance with federal securities laws. Codes of ethics must also require advisers' personnel to report their personal securities holdings and transactions, including those in affiliated mutual funds, and require personnel to obtain pre-approval of certain investments. The Commission is amending the Advisers Act recordkeeping rule to require advisers to keep copies of their codes of ethics and records relating to the code. The Commission is also amending the client disclosure requirements under Part II of Form ADV to require advisers to describe their codes of ethics to clients.

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