Proskauer

Private Investment Funds Update

December 2009

Congress Moves Closer to Taxing Carried Interest as Ordinary Income

On December 9, 2009, the U.S. House of Representatives, by a vote of 241-181, passed H.R. 4213, the Tax Extenders Act of 2009 (the "Extenders Act"). This legislation would extend a number of expiring tax provisions, while raising offsetting revenue by taxing the "carried interest" of fund managers as ordinary income. The Extenders Act adopts, with only minor modifications, the carried interest tax provisions of H.R. 1935, which was introduced on April 2, 2009 by Representative Sander Levin (D-MI).

If enacted in its current form, this legislation would have a dramatic impact on the taxation of many fund managers, including managers of most private equity funds and some hedge funds. Under current law, the tax character of carried interest is determined at the partnership level based upon the character of partnership income, so that carried interest received by many investment funds is taxed at the federal long-term capital gains rate of 15%. The Extenders Act, if passed, would increase the federal tax on carried interest to a rate in excess of 37%, after factoring in employment taxes. The carried interest provisions of the bill generally would apply to tax years ending after December 31, 2009.

President Obama has indicated that he will sign the Extenders Act. It is unclear, however, if the Senate will adopt the carried interest tax provisions of this bill. Timing of enactment also is uncertain, as the Senate could pass the bill early next year, without modifying the current effective date.

The full text of the Proskauer Client Alert on this topic is available here.

Annual Compliance Actions for Investment Advisers

As the end of the year approaches, investment advisers should remember to take any actions that must be taken annually (not necessarily based on a calendar year), including:

- offering to provide Part II of Form ADV to all clients (in the case of registered advisers);

- providing annual privacy notices to natural person clients (in the case of both registered and unregistered advisers);
- performing and documenting an annual review of all compliance programs, policies and procedures (in the case of registered advisers);
- making any required Schedule 13G filings, Form 13F filings and Form 5 filings (within 45 days after the adviser's fiscal year end);
- providing annual VCOC certificates if required by fund partnership agreements; and
- providing any investor specific reporting information as required by any side letters.

Extenders Act Contains New Foreign Tax Compliance Provisions

The Extenders Act also contains provisions from the Foreign Account Tax Compliance Act of 2009 ("FATCA") that would crack down on the use of foreign financial institutions, trusts and corporations by U.S. individuals to evade U.S. taxes.

The main provisions of the legislation would:

- create an expansive and complicated reporting and withholding tax regime intended to force foreign financial intermediaries and investment vehicles to identify U.S. account holders and investors, including those investing through foreign entities with "substantial U.S. owners" (defined below). Under this regime, a 30% U.S. withholding tax would be imposed on the gross amount of income payments from U.S. financial assets (including gross proceeds from the disposition of any property that can produce U.S. source interest or dividends) to a foreign financial entity, unless it has entered into an agreement with the IRS to obtain and report information about its U.S. investors, including those investing through a foreign entity whose U.S. investors hold a greater than 10% direct or indirect interest in such foreign entity (referred to as "substantial U.S. owners");
- impose a similar withholding requirement on payments from U.S. sources to a foreign non-financial entity (which could include private investment funds), unless it discloses to the payor the identity of all substantial U.S. owners, and this information is in turn reported by the payor to the IRS;
- eliminate the exception from the registration requirements for debt obligations for foreign-targeted debt. This change generally would eliminate deductions for interest paid with respect to such unregistered debt and subject interest payments on such debt to U.S. withholding tax;
- treat certain "dividend equivalent" payments as dividends for tax purposes. This generally would subject to U.S. withholding tax certain swap payments and other

substitute payments that are similar economically to dividends but currently avoid U.S. tax; and

- enact additional reporting requirements for foreign bank accounts and investments and make changes to penalties and the statute of limitations for failure to report.

There are varying effective dates for these provisions. While some provisions are proposed to take effect beginning in the first taxable year after the date of enactment, the significant withholding tax penalties imposed by the legislation on the failure to comply with its reporting requirements will only apply to payments made after December 31, 2012.

SEC Approves Amendments to the Custody Rule

On December 16, 2009, the SEC approved amendments to Rule 206(4)-2 of the Investment Advisers Act of 1940, as amended (the "Custody Rule"). The SEC has not yet published the adopting release or final text of the amendment, so this discussion is based on reports of the actions taken at the public meeting.

Generally, all registered investment advisers with custody of client funds or securities would be required to have an independent public accountant conduct an annual surprise audit of client accounts. If the investment adviser or an affiliate of the adviser holds client assets as a qualified custodian, the surprise audit would have to have been performed by an independent public accountant registered with, and subject to regular inspection by, the Public Company Accounting Oversight Board ("PCAOB").

However, based on the discussion of the amendments to the Custody Rule during the SEC's meeting on December 16, it appears that there will be at least two exceptions to the annual surprise audit requirement:

- Advisers to pooled investment vehicles that obtain an annual audit of their financial statements from an independent public accountant registered and subject to oversight by the PCAOB may not be subject to an annual surprise audit.
- In the event a registered investment adviser uses a third party qualified custodian, and the adviser's only access to client funds and securities is the ability to deduct advisory fees, then the Custody Rule may not require an annual surprise audit.

Interestingly, it appears that the SEC will also require auditors who cease to provide services to a registered investment adviser to engage in a "noisy withdrawal" by explaining to the SEC the reason for the termination of the relationship.

House Passes Financial Reform Legislation

On December 11, 2009, the House of Representatives approved The Wall Street Reform and Consumer Protection Act (H.R. 4173). The bill, passed by a vote of 223-202, seeks to address many of the financial practices believed to have caused the crisis in financial markets in 2008.

The bill covers a wide swath of financial regulation. In the area of systemic risk, the bill would require all lenders/creditors to retain a minimum of five percent of the credit risk associated with any loans that are transferred, sold, or securitized. The bill would restrict the ability of the FDIC or Federal Reserve to bail out failing financial institutions, and replaces those bailout mechanisms with a mechanism for the orderly dissolution of failing firms. Financial regulators will be authorized to dissolve large, highly complex financial companies in a manner that allocates losses to both shareholders and creditors. Upon the dissolution of a financial institution, dissolution costs will be borne first from the assets of the failed firm. The bill establishes a Systemic Dissolution Fund ("SDF") to pay the costs of dissolution to the extent such costs exceed the assets held by the failed firm. The SDF will be pre-funded by assessments on financial companies with assets in excess of $50 billion and hedge funds with assets in excess of $10 billion.

All "financial institutions" (including investment advisers to hedge funds or private equity funds) with assets of more than $1 billion would be subject to new standards to proscribe inappropriate or imprudently risky compensation practices, and would be required to disclose compensation structures that include any incentive-based elements. Unfortunately, it is unclear from the current draft of the bill whether the $1 billion in assets refers to the assets managed by the adviser, or the assets of the manager itself.

The bill requires all advisers to private pools of capital with more than $150 million in assets to register with the SEC. The bill also eliminates the private adviser exemption and limits other exemptions for foreign private fund advisers. In its current form, the bill exempts venture capital companies and Small Business Investment Companies.

The bill would establish the Consumer Financial Protection Agency (the "CFPA") to protect the public from unfair and abusive financial products and services. The CFPA will have jurisdiction over all financial providers, including banks, thrifts, credit unions and non-bank financial institutions and will implement rules under existing consumer finance laws to stop unfair, deceptive and abusive consumer financial products and services.

The bill also expands the SEC's rule-making authority to cover municipal financial advisors, illiquid investments by mutual funds, information collection and anti-fraud with respect to short sales. The SEC would be authorized to restrict the use of mandatory arbitration clauses in contracts with broker-dealers. In addition, the SEC would be granted rulemaking authority with respect to the lending and borrowing of securities, but the bill expressly states that such rulemaking shall not limit the authority of federal banking regulators to regulate the securities lending and borrowing activity of a financial institution on safety and soundness grounds, or to protect the financial system from systemic risk.

The full text of the Proskauer Client Alert on this topic is available here.

FASB Agrees to Defer Consolidation Rule Application for Asset Managers

Proposed guidance tentatively approved on November 11, 2009 by the Financial Accounting Standards Board will enable asset managers to avoid consolidating the funds that they manage on their balance sheets under consolidation rules to be effective in 2010. The application of Statement of Financial Accounting Standard 167 will be deferred for these entities until the joint project on consolidations by FASB and the International Accounting Standards Board is completed in late 2010.

The deferral of the new consolidation rules is available only to entities that meet certain conditions, which conditions are generally satisfied by most mutual funds, hedge funds and private equity funds. The deferral is not available to securitization entities, asset-backed financing entities, and entities formerly deemed "qualifying special purpose entities" under FASB's old rules on transfers of financial assets. In addition, FASB voted to propose a deferral of the effective date of the consolidation rules for money market mutual funds that must comply with or operate within the requirements of Rule 2a-7 of the Investment Company Act of 1940.

The board expects to vote on final guidance regarding the interim treatment of investment managers and funds, pending completion of the joint FASB/IASB project on consolidations, in the first week of January.

CalPERS President Calls for New State Rules Regarding Placement Agents

Rob Feckner, President of the California Public Employees' Retirement System's ("CalPERS") Board of Administration, has directed CalPERS staff to pursue legislation that would require placement agents to register as lobbyists and be subject to strict reporting and ethics rules under the California Political Reform Act.

The proposed legislation would define placement agents as lobbyists, prohibit compensation to placement agents that is contingent upon defeat, enactment or outcome of any proposed investment action, require registration of and quarterly reporting by placement agents (including reporting of any honoraria, gifts, fees or other compensation), place limits on gifts to individuals and prohibit campaign contributions, and require attendance by placement agents at a biennial ethics class.

The new legislation would be in addition to an internal CalPERS policy established in May that requires CalPERS' investment partners and external managers to disclose their retention of placement agents, the fees they pay them and the services performed. The policy also requires placement agents to register as broker-dealers with the SEC or FINRA, or CalPERS will decline the opportunity to retain or invest with the external manager.

FINRA Fines Broker-Dealer for Making Improper Soft-Dollar Payments for Hedge Fund

A Chicago broker-dealer was fined $400,000 by the Financial Industry Regulatory Authority ("FINRA") for making more than $1 million in improper soft-dollar payments to or on behalf of five hedge fund managers, without following its own policies to ensure the payments were proper. FINRA found that, starting in 2004, the broker-dealer set up soft-dollar accounts for eight hedge funds to encourage the funds to execute trades with the firm. Funds from these soft-dollar accounts were then used to pay invoices from the fund managers or third parties for various services, some of which (for estate planning fees, administrative staff and accounting expenses) were not allowed by the fund documents. Other payments made directly to the funds' managers were deemed improper because the broker-dealer did not receive written third-party authorizations required by fund documents that the firm had or should have obtained under its policies.

The broker-dealer was charged with failing to properly supervise its soft-dollar program, failing to implement adequate supervisory procedures, and failing to retain its business-related electronic instant messages. FINRA also sanctioned three of the broker-dealer's employees, imposing fines ranging from $10,000 to $20,000. As part of the settlement, the broker-dealer is required to retain an independent consultant to review and enhance its policies, systems and procedures relating to its soft-dollar operations.

New CFTC Rules Significantly Amend Reporting Requirements Applicable to Commodities-Focused Hedge Fund Managers

On November 9, 2009, the Commodity Futures Trading Commission ("CFTC") adopted several amendments to its regulations regarding the reports to be provided to investors in commodity pools by CFTC-registered commodity pool operators ("CPOs"). The new rules:

- specify detailed information to be included in periodic account statements and annual reports for commodity pools with more than one series or class of ownership interest;
- clarify that periodic account statements must disclose either the net asset value per outstanding participation unit in the pool or the total value of a participant's interest in the pool;
- extend the deadline for filing and distributing annual reports of commodity pools that invest in other funds;

- codify existing CFTC staff interpretations regarding proper accounting and financial statement presentation of certain income and expense items;
- streamline annual reporting requirements for pools ceasing operation;
- establish conditions for use of IFRS in lieu of U.S. GAAP; and
- clarify and update several other requirements for periodic and annual reports to be prepared and distributed by CPOs.

The rules become effective on December 9, 2009 and will apply to commodity pool annual reports for fiscal years ending December 31, 2009 or later.

Final Model Privacy Notice Form Issued by Federal Regulators

On November 17, 2009, the eight federal regulatory agencies (the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Federal Trade Commission, the National Credit Union Administration, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission) released a model privacy notice form for financial institutions. (Both formats of the model form are accessible here .) The new model form is intended to make it easier for consumers to understand how financial institutions, including investment advisers, hedge funds and private equity funds, collect and share information about consumers.

Financial institutions are obligated under the Gramm-Leach-Bliley Act to notify consumers of their information-sharing practices and to inform them of their right to opt out of certain such practices. The Financial Services Regulatory Relief Act of 2006 required that the federal regulators propose a model notice form that enabled easy comparison of the privacy practices of different financial institutions.

The final rule provides that a financial institution that uses the model form obtains a "safe harbor" with respect to the disclosure requirements for notices. The sample clauses that were appended to the old privacy rule are being phased out after a one-year transition period. While the model form provides a legal safe harbor, institutions may continue to use other types of notices, including their current forms of notice containing the sample clauses, if these notices comply with the privacy rule. For example, an institution could continue to use a simplified notice if it does not have affiliates and does not intend to share nonpublic personal information with nonaffiliated third parties outside of the exceptions provided.

Mutual Fund Annual Return Regime in British Virgin Islands Now Mandatory

On November 12, 2009, the British Virgin Islands ("BVI") Financial Services Commission ("FSC") made it mandatory for all public, private and professional funds defined as "mutual funds" in the Mutual Funds Act, 1996 (as amended), to file an Annual Return with the FSC. This submission formerly had been voluntary.

The Annual Return is completed in U.S. dollars, and includes information such as the type of fund, its constitution and operating structure, its registered agent and certain service providers, a summary statement of financial position, general asset allocation and asset allocation by jurisdiction, investment information and a summary of fund expenses. If a fund has a BVI-incorporated investment manager, but the investment management services are not provided from within the BVI, the fund is required to disclose the jurisdiction from where such services are provided.

Annual Returns for the year ended December 31, 2008 were required to be filed no later than November 15. However, the FSC does not intend to impose penalties upon mutual funds who submit Annual Returns prior to the end of this year. **Annual Returns for 2009 and subsequent years should be submitted no later than June 30 of the following year. The information submitted to the FSC will only be used for statistical and compliance purposes, and will not be shared outside the FSC other than on an aggregate basis or as required by law.**

Update #2 on the Proposed EU Directive on Alternative Investment Fund Managers

On November 12, 2009, the Swedish EU Presidency of the Council of the European Union published a compromise proposal amending the draft EU Directive on Alternative Investment Fund Managers (the "Directive"). The compromise proposal sparked controversy by adding provisions requiring fund managers to have remuneration policies for key personnel, and to appoint a remuneration committee in certain cases. Variable remuneration, including bonuses and carried interest, would be subject to a required deferral of 40 percent (or 60 percent if the amount is "particularly high") over at least a three-year period. Soon after, the Swedish Presidency published a revised compromise proposal on November 25 which dropped the proposed three-year deferral of up to 60% of bonuses in favor of a deferral "over a period which is appropriate in view of the life cycle and redemption policy" of the fund, and included a carve-out for returns to employees from their investments in funds.

Under the compromise proposal, authorization would be required for firms that "manage" alternative investment funds, meaning the performance of portfolio management and risk management. An authorized fund manager could delegate or outsource certain of these functions, but would remain responsible for their proper execution. The trigger thresholds regarding assets under management remain the same under the new proposal (€100 million, or €500 million for unleveraged closed-ended funds).

EU-based fund managers could manage non-EU funds, provided that legislation in the non-EU country meets standards set by international organisations such as IOSCO, and that a cooperation agreement exists between the relevant regulators. However, the Europe-wide private placement regime for professional investors would be available only where the fund itself (and any master fund into which such a fund invests) is established in the EU. Non-EU funds would continue to have to be marketed under national private placement regimes. Non-EU fund managers would not be required or eligible to seek authorization under the Directive, even for marketing purposes, and would therefore not be able to take advantage of the new pan-European placement regime. If national private placement regimes continue to be available this is not a significant concern, but the terms on which non-EU fund managers will be able to market to and raise funds from EU investors are still unclear.

The compromise clarifies that managers of AIFs would be required to have "own funds" as per the Capital Requirements Directive, broadly, ¼ of the manager's annual expenses, in addition to initial capital of €125,000. Managers of private equity funds under the €500 million threshold who make investments and divestments solely on an infrequent basis, do not employ leverage, and whose funds do not have redemption rights within five years from the fund's establishment will be subject to an initial capital requirement of €50,000/60,000 (broadly the same as the regulatory capital requirement that already applies to some UK based FSA-regulated private equity firms).

Limits on leverage would be imposed under the proposal only where the stability and integrity of the financial system is threatened, and would only target leverage used as part of investment strategy (reducing concerns over equity bridge facilities). The compromise proposals eliminate the independent valuation requirement, and instead require firms to implement proper valuation procedures using appropriate valuation models. However, individual Member States would be permitted to require either the valuation procedures or the valuations themselves to be independently audited. The compromise proposals would still require all funds to appoint a separate depositary with responsibility for custody of investments, verification of title to assets, and ensuring that investor subscriptions and fund valuations are carried out in accordance with the fund documents. Since it is also proposed that the depositary should be directly liable to investors for losses resulting from custody failures, there is substantial concern over increased fees.

The European Council has indicated that it cannot agree to the Swedish Compromise in principle, and therefore responsibility for reaching an agreement on a revised Directive will pass to the Spanish EU Presidency as of January 1, 2010.

On November 23, 2009, Jean-Paul Gauzès, the French Member of the European Parliament ("MEP") steering the proposals through the European Parliament, issued a report containing about 130 potential amendments, which among other things would maintain national private placement regimes and align the Directive with existing EU measures. The Economic and Monetary Affairs Committee MEPs have until January 21, 2010 to table amendments to the report. We understand amendments are likely to be debated in committee on February 22 and put to a committee vote on April 12. The plenary vote of the European Parliament is scheduled for July 2010.

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