

I N S I D E T H E M I N D S

Raising Capital for Private Equity Funds

*Leading Lawyers on Navigating Recent Trends in
Fund Formation, Understanding Legal and
Contractual Hurdles, and Developing Creative
Strategies for Raising Capital*



ASPATORE

©2009 Thomson Reuters/Aspatore

All rights reserved. Printed in the United States of America.

No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, except as permitted under Sections 107 or 108 of the U.S. Copyright Act, without prior written permission of the publisher. This book is printed on acid free paper.

Material in this book is for educational purposes only. This book is sold with the understanding that neither any of the authors nor the publisher is engaged in rendering legal, accounting, investment, or any other professional service. Neither the publisher nor the authors assume any liability for any errors or omissions or for how this book or its contents are used or interpreted or for any consequences resulting directly or indirectly from the use of this book. For legal advice or any other, please consult your personal lawyer or the appropriate professional.

The views expressed by the individuals in this book (or the individuals on the cover) do not necessarily reflect the views shared by the companies they are employed by (or the companies mentioned in this book). The employment status and affiliations of authors with the companies referenced are subject to change.

Aspatore books may be purchased for educational, business, or sales promotional use. For information, please email West.customer.service@thomson.com.

For corrections, updates, comments or any other inquiries please email TLR.AspatoreEditorial@thomson.com.

First Printing, 2009

10 9 8 7 6 5 4 3 2 1

If you are interested in purchasing the book this chapter was originally included in, please visit www.west.thomson.com.

Resilience under Fire: How
Private Equity Fund Sponsors
Are Responding to Challenges
Posed by the Financial Crisis,
Investor Demands, and
Aggressive Proposed Tax
and Regulatory Changes

David Goldstein, Scott Berger, Monica K. Arora,
John T. Lillis, and Jeremy M. Naylor

Partners

White & Case LLP



ASPATORE

One thing that is clear at the present time is that this is the toughest environment for fundraising for private equity and other closed-end private funds in twenty years. Over the last two decades, the alternative asset management business has evolved and grown to a degree that few, if any, would have predicted. The lessons learned over those years can provide private fund sponsors, investors, and other people focused on the business (such as placement agents and lawyers) with the ideas and inspiration needed to survive and ultimately flourish during these challenging times.

In this chapter, we survey the current private equity fundraising efforts and analyze the implications of the identified trends. We also discuss in depth one of the most important challenges private fund sponsors are facing today: the risk of investor defaults, and the resulting growth of secondary transactions involving private fund interests. Lastly, we explore the techniques savvy fund sponsors are using to help raise new funds and the legal, contractual, and regulatory hurdles, both new and potential, that fund sponsors must manage in order to succeed today and in the near term.

Identified Trends

Where Is the Opportunity? Traditional Strategies That Work Today

Distressed Debt and Distressed Real Estate Funds

The global economic crisis has resulted in the emergence of many opportunities in the distressed debt and distressed real estate market of which fund sponsors and investors alike have sought to take advantage. According to alternative asset research and consultancy group Preqin, in 2008, twenty-three distressed private equity funds raised \$43 billion. The pace of fundraising in this sector remains brisk.¹ However, despite the bullish outlook of some fund

¹ For example, in early 2009, New York-based Angelo Gordon & Co. launched AG Capital Recovery Partners VII LP, a distressed debt fund, with the goal of securing \$3 billion in capital commitments to invest in secured senior debt instruments of companies near or in Chapter 11. See *LA Fire Squeezes Two More Pledges from '08 PE Allocation*, Buyouts, February 2, 2009. Also in early 2009, Dallas-based Lone Star Funds commenced fundraising a targeted \$10 billion for a new vehicle, Lone Star Fund VII LP, to invest in distressed residential mortgages and defaulting corporate bonds and loans primarily in the United States. However, distressed debt funds have not limited their outlook to the United States, as significant commitments have been raised for distressed debt of Asian companies. According to *Private Equity Insider*, in June 2009, New York-based Clearwater Capital began marketing

sponsors and investors, distressed debt funds have also suffered from difficult fundraising conditions. According to data from San Francisco-based placement agent and alternative investment advisory firm Probitas Partners, in the first half of 2009, thirteen distressed debt funds raised \$5.7 billion, compared to twelve such funds raising \$18 billion in the first half of 2008.

Commitments have also been flowing to sponsors investing in distressed real estate because of the credit crisis. According to a February 2009 report from Preqin, more than one-third of the capital being raised by real estate private equity funds at that time was targeting distressed debt and assets.² This compares with the record \$116.7 billion raised by real estate private equity funds in 2008, of which 26 percent was raised for distressed investments, the report said.

Infrastructure

The last several years have seen considerable growth in the infrastructure fund market. According to Preqin, in 2008, twenty-three infrastructure funds raised approximately \$26 billion, and investor appetite for infrastructure and similar opportunities available for sponsors bolstered the average size of all infrastructure funds to \$3.3 billion by October 2008 from \$159 million in 2003. In the current economic climate, infrastructure assets have been particularly attractive to investors, in large part because of the ability of such assets to provide steady cash flows and a hedge against inflation. Despite difficult fundraising conditions, several fund sponsors remain bullish on infrastructure strategies.³ However, infrastructure funds have not been immune to the difficult fundraising conditions in today's climate. Given the large amounts of capital required and leverage utilized on most infrastructure deals, difficulty in securing credit has particularly hurt

Clearwater Capital Partners IV, a distressed debt fund seeking \$1 billion in capital commitments to invest in distressed debt located in Asia.

² For example, at the same time that it launched Lone Star Fund VII LP, Lone Star Funds also began raising \$10 billion for another vehicle, Lone Star Real Estate Fund II LP, to invest in distressed commercial real estate assets.

³ For example, one of the larger private equity funds currently in market is Macquarie European Infrastructure Fund III (MEIF III), sponsored by Sydney-based Macquarie Funds Group. MEIF III was launched to take advantage of infrastructure investment opportunities within the expanding European Union. MEIF 3 is targeting €5 billion in capital commitments and has raised more than €1 billion to date.

fundraising efforts by infrastructure funds. For example, in April 2008, Goldman Sachs Group announced that it would target \$7.5 billion in capital commitments for its sophomore infrastructure fund, GS Infrastructure Partners II, but there are indications that the amount of capital raised is currently short of target at \$2 billion. Sponsors of infrastructure funds have reacted differently to these difficult fundraising conditions. Some, according to Preqin, have responded by extending targeted closing dates, while others have postponed fundraising efforts entirely.

Commodities/Energy

According to Dow Jones in May 2008, fundraising by private equity firms in the commodities and energy sector was up 85 percent compared with the same period in 2007. Energy and commodities funds have become popular for some of the same fundamental reasons as infrastructure funds (i.e., steady cash flows and a hedge against inflation). However, energy and commodities funds have also faced similar difficulties (i.e., difficult fundraising conditions and difficulty in securing credit), with sponsors falling short of their targets.

Senior Loan Funds

According to an October 2008 interview with Michael Powell, head of alternative assets for the United Kingdom's second-largest pension, Universities Superannuation Scheme, senior loan funds would be in demand in 2009. To meet the expected demand, Los Angeles-based Oaktree Capital announced in the first quarter of 2009 that it would seek upwards of \$2 billion for a senior loan fund, and Dallas-based Highland Capital Management announced in July 2009 that it is currently marketing a senior loan fund, targeting \$1 billion in capital commitments.

Emerging Market Funds (Brazil)

In a 2009 survey by the Emerging Markets Private Equity Association asking limited partners about their plans for investing in emerging markets, Brazil was surpassed only by China in attractiveness for investment. According to Luiz Eugenio Figueiredo, president of the Brazilian Private Equity and Venture Capital Association and a partner at Rio Bravo

Investimentos, one reason that Brazil's private equity industry has been less vulnerable to the global credit crisis than others is because it does not rely heavily on leverage.⁴ Private equity firms are bullish about investing in Brazil, in large part due to an increasingly open regulatory regime and the perceived diversity and abundance of private investment opportunities.⁵ For example, in October 2007, GP Investments, a Brazilian private equity firm, closed its fourth fund, GP Capital Partners IV LP, at \$1.3 billion, well above its \$600 million target.⁶ In early 2009, GP Investments announced plans for a new fund that would be larger than its predecessor, stating that "global investors—especially U.S. pension funds and sovereign wealth funds with a long-term view—see Brazil as an attractive opportunity when compared with other emerging markets."⁷

Lost Opportunities: Strategies That Won't Work

Real Estate Funds

According to Preqin, fundraising by real estate private equity firms reached a five-year low in the second quarter of 2009. Although real estate funds represent a highly differentiated range of funds, including opportunistic, distressed, distressed debt, performing debt, "stressed" debt, hospitality, and core, some of which have not completely lost favor with investors, the stress in the real estate markets is acute, and many sponsors are spending a great deal of time salvaging portfolios that are valued below the related debt. In addition, the gulf between real estate buyers and sellers is so wide, and the supply of credit so tight, that opportunities to deploy capital in new investments are very limited. In this environment, the only real estate-related strategies for which investors are showing significant interest are those that seek to take advantage of the current market turmoil or those that are focused on core assets, generating reasonable risk-adjusted cash returns.

⁴*Latin Flourish*, Financial Times Mandate, May 2009, available at www.ftmandate.com/news/fullstory.php/aid/2060/Latin_flourish.html

⁵ *The Future of Brazilian Markets: A Private Equity Perspective*, Seeking Alpha, July 2009, available at seekingalpha.com/article/147086-the-future-of-brazilian-markets-a-private-equity-perspective

⁶ *GP Investments Closes \$1.3bn Fund*, AltAssets, October 22, 2007, available at www.altassets.com/private-equity-news/by-region/latin-america/article/nz11891.html

⁷ *Brazilian Private Equity: Cash Is God but Creativity Is Vital*, Euromoney, March 4, 2009, available at www.euromoney.com/Print.aspx?ArticleID=2118711

As of July 2009, thirty-six real estate funds have been abandoned or put on hold, compared with twenty-five funds that were abandoned or put on hold in all of 2008, the Prequin report said. Nevertheless, the report offers some good news that “investors are generally positive toward the long-term future of the asset class, with 84 percent of investors polled indicating that they would be returning to invest in the medium- to long-term.”

Buyout Funds

Buyout firms have experienced a steep drop in fundraising activity, as investors have stopped committing to the private equity asset class and many sponsors have delayed coming to market. According to statistics from Private Equity Analyst, buyout fundraising in the first six months of 2009 was down by 72 percent to \$28.7 billion from the same period in 2008. “Buyout firms experienced one of the steepest drops, as they faced not only the denominator effect⁸ but questions specific to how banks’ ongoing unwillingness to provide debt affects their strategy,” according to Dow Jones LBO Wire. With the difficulty in financing and current market skepticism toward highly leveraged deals valued in the billions of dollars, private equity firms have looked for opportunities lower in the middle market. As a result, small and mid-sized buyouts by funds are still taking place, and fund sponsors have been active in raising funds focusing on such buyouts.

Notwithstanding the difficult fundraising environment for buyout funds, there have been some success stories resulting from a flight to quality, or at least reputation. For example, Palo Alto-based Hunstman Gay Global Capital LLC held a final closing for its debut fund, raising \$1.1 billion. Hunstman Gay Capital Partners Fund I, which was targeting \$1 billion in capital commitments, was formed to stage leveraged buyouts and investments in the middle market. The private equity firm’s partners include retired NFL star Steve Young and former Citigroup Inc. executive Gary Crittenden. According to Young, the firm’s success could be attributed to “the middle market deal-making background of its senior partners, a large

⁸ The denominator effect is the quandary faced by an investor when the value of certain assets in its portfolio (e.g., stocks and bonds) fall relative to the value of other, more illiquid assets (e.g., private equity fund interests) causing such assets to rise above allocation targets, which may trigger the need to rebalance a portfolio.

capital commitment from firm management, and its tight group of limited partners totaling about a dozen institutions.” Also helpful to the firm’s fundraising efforts was the pledge by the firm’s founders, Huntsman and Gay, to give their share of carried interest profits to various charitable organizations.

New Opportunities

Real Estate Investment Trusts

Although the fundraising climate has cooled for traditional real estate funds (with the exception, noted above, of distressed real estate), several high-profile sponsors are attempting to raise capital through listings of real estate investment trusts to acquire distressed commercial mortgage-backed securities. Apollo Capital Management, Alliance Bernstein, and Colony Capital, among others, have announced plans to raise nearly \$4 billion in new capital to purchase and manage distressed commercial mortgage-backed securities. And on August 12, 2009, Starwood Property Trust Inc. raised \$810 million in an initial public offering for the same. These sponsors may have sensed that there is more appetite among potential real estate investors for a vehicle that offers more liquidity, such as a real estate investment trust, than a traditional private fund where investors’ capital is typically locked up for a significant period of time. Furthermore, real estate investment trusts raise capital through the issuance of common stock, thus providing permanent capital. Unlike a fund, there is no requirement to return capital, whether through distributions or redemptions. This allows for a more long-term strategy, constrained only by the stock’s performance in the markets.

Secondaries

Despite the difficult fundraising environment for private equity funds generally, 2009 has been a record year for secondary firms. Secondary firms purchase limited partnership interests from existing investors in private equity funds who are looking for liquidity or who are no longer willing or able to meet capital calls. According to statistics from Private Equity Analyst, in the first half of 2009, these firms raised \$15.6 billion across twenty-two funds, a full-year fundraising record for the sector and nearly

five times the \$3.3 billion raised by twelve funds through the first half of 2008. The final closing of Goldman Sachs's GS Vintage Fund V LP in April 2009, the largest secondary fund ever raised, boosted this number. GS Vintage Fund V was able to raise close to \$6 billion, almost twice the amount raised for its predecessor fund, GS Vintage Fund IV, in March 2007. Even more recently, in July 2009, New York-based Pomona Capital announced that it held a final closing for its seventh secondary offering, raising nearly \$1.3 billion, exceeding its target of \$1 billion.

Annex Funds

In light of the slow exit market, a large number of cash-strapped fund sponsors are also looking for creative ways to address the capital needs of their existing portfolios. In addition to approaches such as amending the fund's governing documents, for example, (i) to expand the sponsor's ability to recycle capital previously returned and (ii) to extend the fund's term to permit additional time for the sponsor to contemplate exit options for the existing portfolio, sponsors are also exploring ways to raise additional capital for their existing portfolios.

To address the need of their existing portfolios, a number of sponsors have raised smaller "annex funds" designed to infuse additional capital (committed by new or existing investors) into an existing portfolio. Typically, an annex fund is raised out of necessity, and therefore may include preferential terms that incentivize investor participation, including high preferred returns (ranges to 20 percent and higher), no fees or carry, and a commitment fee, generally of one to two points, to investors on undrawn capital. These terms have been sufficiently attractive for many investors to pursue investments in annex funds. However, many other investors, including existing investors, may not find the option appealing because of concerns with the historical performance of annex funds generally, with the prospect of investing in a failing portfolio, and with the conflicts of interest raised by such funds, particularly with respect to the potential dilution of the interests of existing investors.

A sponsor is typically required to obtain investor consent or advisory committee consent from the existing fund in order to raise an annex fund. Even when such consent is not required by the fund's governing

documents, it is generally best practice for a fund sponsor to obtain consent from existing investors prior to marketing an annex fund. Communication with existing investors is also a crucial step toward a successful fundraise. Existing investors, whether or not they participate, need to appreciate the need for the cash infusion and how the new funds will be used.

Responding to Funds in Distress

Limited Partner Defaults

Until recently, the default provisions in a fund partnership agreement were a subject of little discussion between sponsors and investors. Sponsors and investors alike assumed that investors would not default on their financial obligations to the fund, and that default provisions are mutually protective of all interests in a fund. However, current market conditions are forcing investors to consider their options when capital is called, including the decision to default on a capital call.

Reasons for Default

An investor may be forced to default on a capital call for a number of reasons. As realizations from private equity investments have ceased for the most part, equity reserves have fallen, and borrowing has been restricted, investors are having a harder time finding the liquidity needed to meet capital calls. Alternatively, an investor may choose to default either because a fund has sustained substantial losses and the investor has lost faith in the management or as a means of reallocating its portfolio, given that the value of so many of its other investments may have tumbled. When choosing to default on an obligation to a fund, an investor must consider its own reputation in the funds community and its access to investment opportunities going forward. However, given the huge numbers of investors forced to default or choosing to do so, many believe that the stigma of failing to meet a capital call has diminished greatly.

Limiting Future Investments/Reducing Obligations

To avoid actually defaulting on a capital call (or the need to threaten a fund sponsor with a failure to fund a capital call), an investor or group of

investors may try to persuade a fund sponsor to curtail investments for a period of time or to end the fund's investment period. This would provide relief to cash-strapped investors, as well as give the sponsor the opportunity to focus on the investments it has already made and limit additional losses. However, a fund sponsor must bear in mind its duties to investors as a whole. Some investors may object to the arm-twisting tactics of others and be concerned that the fund is on the sideline while management fees are paid on uninvested capital. Similarly, a handful of recently formed mega-funds have permitted investors to reduce their capital commitments, and in some cases, have reduced management fees, in large part, to appease investors' liquidity concerns and mitigate the risk of defaults.

Default Options

The governing documents of a fund (i.e., the partnership agreement⁹) typically allow the sponsor (i.e., the general partner) to select, in its sole discretion, from among an array of options when faced with an investor's (i.e., limited partner's) failure to meet a capital call. Typical provisions include declaring a limited partner in default, forcing a transfer of limited partnership interests to existing limited partners or third parties at reduced rates, forfeiture by the limited partner of all or part of the defaulting interest, acceleration of all unpaid capital commitments, removal of voting rights, termination of side letter benefits, and litigation to force a capital payment or payment of damages. In selecting from among its available options, the general partner will need to balance its fiduciary duties to, and the liquidity needs of, the fund, its relationship with both the defaulting limited partner and the non-defaulting partners, and its reputation going forward.

Declaring a limited partner in default is generally not automatic—a general partner must affirmatively deem a limited partner in default in order to employ its other remedies. It may not be prudent to declare a limited partner in default if such limited partner is willing to work with the general partner to resolve the liquidity issues or identify another party to assume its interest in the fund. Declaring a partner in default may, for example, impact agreements related to underlying investments or existing credit facilities. On the other

⁹ Private equity funds are often, but not always, structured as partnerships. In a partnership, the sponsor serves as the general partner and the investors serve as limited partners.

hand, if a general partner decides not to declare a limited partner in default upon its failure to fund a capital call, it will have to justify its decision to the other investors in the fund, and may be forced to rely on the precedent when faced with future failures to fund capital calls by this and other investors in the fund. Note that suits against limited partners in a fund are extremely rare. We know of only one case in Delaware in which a general partner sued a limited partner for the failure to fund a capital commitment.¹⁰ Any suit by a general partner against a limited partner may adversely affect the reputation of the general partner and affect its ability to raise capital for a future fund.

Fiduciary Duties

Under Delaware law, at a minimum, a general partner is required to act in good faith and deal fairly with the fund. As such, when applying one or more of the alternatives available to it, a general partner must consider, among other things, whether it is in the fund's best interest to declare the partner in default, whether the non-defaulting limited partners have an interest in any amounts forfeited by the defaulting limited partner, and whether all limited partners who default must be treated equally. The general partner must consider whether it would be willing to employ the same actions against a later defaulting investor that it does against the first. For example, if the general partner permits a limited partner to opt out of an investment and otherwise retain all rights in the fund rather than default on the capital call for such investment, it may be at risk of violating its fiduciary duties by not treating all partners equally if it takes stronger action against another limited partner for failing to participate in an investment, such as forfeiting some of such partner's interest in the partnership. In addition, to the extent the fund's partnership agreement requires the general partner to disclose defaults to other limited partners (in some cases, even before a partner is declared a "defaulting limited partner"), the general partner's options may be effectively reduced.

¹⁰ See *Capgen Capital Advisers LLC v. Chalice Fund LP* (filed in Delaware). The case is still pending.

Legal Pitfalls

General partners facing a default must also be mindful of a number of issues outside of the business context. A general partner must consider whether to apply the remedies across all of the parallel fund vehicles or only to the vehicle in which the investor defaulted. This can be particularly tricky when, as is often the case, the fund consists of multiple parallel vehicles in different jurisdictions with different legal standards, and actions taken in one parallel vehicle may affect the remedies available in other jurisdictions. If a fund limits benefit plan investors to fewer than 25 percent in order to avoid being deemed a plan assets fund under the Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974), a default by any limited partner may require a recalculation to confirm that the fund is still in compliance with the act's requirements. In addition, a default may require the fund to report the default on its financial statements. Finally, a failure to meet a capital call by a limited partner usually requires notice to a lender, even if the limited partner is not deemed a defaulting limited partner. This may trigger the acceleration of outstanding loans or the termination of the credit facility.

Facing a Shortfall

When faced with a capital shortfall due to one or more defaulting limited partners, a general partner may either reduce the size of the fund by the amount of actual or anticipated defaulted commitments, or try to make up the lost amounts for a particular investment or for the fund overall. A reduction in fund size may force a fund to seek fewer and/or smaller investments than originally anticipated (more so for a fund in its earlier stages than one approaching the end of its investment period) and to evaluate its investment strategy and investment restrictions to ensure that the smaller amounts of capital available for draw-down match its investment objectives, including diversification requirements. In addition, a reduced capital commitment will reduce the management fees available to the management team.

In the event of an actual default, a general partner may need to make up a cash shortfall to close a portfolio investment or to meet imminent fees and expenses of the fund. Non-defaulting limited partners are generally

required to cover some portion, up to a certain percentage of their own commitments, of the defaulted contribution. When such amounts are insufficient, the general partner will need to look for capital from other sources, including credit facilities, existing investors, and third-party investors. However, current market conditions have made subscription-backed credit facilities less available and existing limited partners less willing to provide additional capital for investments. Co-investors, including existing investors, outside investors, and other funds, may be willing to participate in a particular investment for which the fund lacks sufficient capital. However, such arrangements will require additional negotiations and supplementary terms for each particular investment and may delay funding the investment. On the other hand, it may be the most effective way of dealing with a liquidity crunch, and it will give the general partner time to adjust its expectations regarding funding going forward. Lastly, a general partner may seek an existing limited partner or a third-party investor to take over the entire obligation of the defaulting limited partner. Since the existing limited partners have already done their due diligence on the fund and its management, they are often the most likely candidates to assume the obligations of defaulting investors. However, in light of the current credit crunch, existing investors may not be in a position to take on greater commitments, so general partners may want to establish relationships with one or more potential third parties, such as secondary funds, who have done their due diligence on the fund and are in a position to acquire interests in the event of a default.

In the current climate, a general partner should be prepared for the possibility that one or more limited partners may fail to fund capital calls. Sponsors should review the default provisions of their governing documents and understand the implications of such provisions and the alternatives available to them. They should also be in regular contact with their investors so that issues can be addressed before a default occurs.

Secondary Transactions

Given the number of private equity fund investors that are no longer able to meet their obligations, a market known as the “secondary market” has

developed whereby existing investors can find buyers to whom to transfer their fund interests. Such transfers allow investors to receive liquidity for funded investments as well as obtain a release from any remaining unfunded obligations to the fund.

Buyers

The field of potential buyers on the secondary market is quite small. Buyers tend to be dedicated secondary investment funds, funds of funds (i.e. private funds dedicated to purchasing interests in other private funds), or institutions that specialize in such purchases since the investment requires substantive due diligence, complex valuations, and immediate liquidity. However, for the appropriate investors, the allure of the secondary market can be strong. Fund interests sold on the secondary market are generally sold at discounted prices, at times to such an extent that the interests cost less than the value of the underlying assets in the portfolio. Such a purchase may allow an investor to purchase interests in a fund that was previously closed to new investors. A secondary buyer is granted greater visibility into the management of a fund and the performance of its portfolio than an initial investor, particularly in the case of management that had no track record prior to the closing of the fund. In addition, secondary buyers will recoup their investments faster than the fund's original investors will because they invest later in the life of a fund.

Valuation Issues

The primary stumbling block in any secondary transaction is the valuation of the secondary interests and the gap in the respective pricing expectations of sellers and buyers. The volatility of today's market exacerbates these issues, as it has been very difficult to ascertain net asset value and the future value of interests.

Closing the Deal

Transfers of interests in private funds are typically subject to the general partner's consent, which generally may be withheld in its sole discretion, though some agreements provide that the general partner's consent cannot be unreasonably withheld. Before consenting to a transfer, a general partner

should seek assurance that the transfer will not cause the partnership to conflict with any applicable laws or regulations. For example, each transfer must be viewed in light of (a) the implications under the Securities Act of 1933, 48 Stat. 74 (1933) (codified at 15 U.S.C. § 77a et seq.); (b) how the status of a transferee affects the fund's exemption from registration under the Investment Company Act of 1940, 54 Stat. 789, (1940) (codified at 15 U.S.C. §§ 80a-1-80a64) and the fund manager's status under the Investment Advisers Act of 1940, 54 Stat. 847 (1940) (codified at 15 U.S.C. §§ 80b-1-80b-21), as amended; (c) tax implications, including the Internal Revenue Code provisions that provide exemptions for private funds from "publicly traded partnership" status; (d) Employee Retirement Income Security Act regulations, including the 25 percent limit on benefit plan investors if the fund does not want its assets to be deemed plan assets under the act; (e) anti-money laundering laws; and (f) applicable state securities or "blue sky" laws. Transferring limited partners and transferees are often required to provide a legal opinion to the effect that the proposed transfer will comply with applicable law. Lastly, a general partner should seek comfort that a potential purchaser is in a financial position to meet all future capital calls and otherwise complies with the provisions of the fund's partnership agreement.

Avoiding Status as a "Publicly Traded Partnership"

Private equity fund documents typically prohibit transfers of interests that result in the fund becoming a "publicly traded partnership" for tax purposes. A publicly traded partnership is a partnership whose interests are listed on an established securities exchange (which is almost never the case with a private fund) or whose interests are traded on a secondary market or its equivalent.

While many transfers of fund interests are privately negotiated and do not involve a market-maker, there are some exchanges, such as the New York Private Partnership Exchange, that stand ready to match buyers and sellers of interests in funds. Transfers of interests on such exchanges (and through similar, but less formalized arrangements if the transfers are routine and ongoing) present the risk that the underlying funds may be treated as publicly traded partnerships.

Such treatment would be disastrous for a private fund. A publicly traded partnership is subject to entity-level tax, resulting in double taxation for some investors and reduced after-tax returns for all investors. Thankfully, the tax law contains several “safe harbors” that allow for limited transfers of interests in funds, even through secondary markets such as the New York Private Partnership Exchange. The most commonly referenced safe harbor is the “2 percent safe harbor” pursuant to which up to 2 percent of interests in capital or profits of a partnership may be traded each year without raising publicly traded partnership issues.

Because of the recent spike in secondary fundraising and privately negotiated secondary transactions, many funds are bumping into this 2 percent limit. Some legal advisers have counseled funds that are running out of room under the 2 percent safe harbor to postpone additional transfers until 2010, when the safe harbor resets. Some funds, in an effort to balance the desires of their partners for liquidity against the publicly traded partnership tax risk, have embraced the use of a “qualified matching service” to facilitate transfers.

A qualified matching service is an additional safe harbor that permits transfers of up to 10 percent of interests in capital or profits in a partnership each year, subject to several technical requirements, including the observation of certain periods between the matching of buyer and seller and the ultimate sale. So long as the qualified matching service requirements are met, transfers conducted through the service will avoid triggering the publicly traded partnership rules. Bain Capital is an example of a private equity fund that has established its own qualified matching service to facilitate transfers of interests in its funds. Regardless of safe harbor sought, it is common practice (and is required under many partnership agreements) for the transferor or transferee to obtain an opinion of counsel that a proposed transfer will not raise publicly traded partnership issues.

Role of the General Partner

Aside from consenting to, and possibly facilitating, the transfer of fund interests, a buyer and/or seller may ask the general partner to be further involved with the transfer.

A buyer may request that the general partner (a) confirm the amount of the seller's original capital commitment, funded capital commitment, unfunded capital commitment, distributions received, and the value of in-kind distributions, or (b) represent and warrant that the seller is not in default under any agreement or obligation owed by such seller with respect to the fund. A seller may ask a general partner to unconditionally release and discharge such seller from all obligations and liabilities that may arise under the operative documents upon the assumption by a buyer of all of such obligations and liabilities, as if the buyer had been originally bound by such documents. The general partner may or may not extend to the buyer the benefits and obligations of any side letter between itself and the seller depending, primarily, on the terms of such side letter or on whether a secondary transaction is a transfer in part or in whole of a seller's interest.

In cases where the general partner does not consent to an unconditional release and discharge of the seller, the general partner may agree to first seek compensation from the buyer before seeking payment from the seller. It is important to note that under the Delaware Revised Uniform Limited Partnership Act (Del. Code Ann. tit. 6, chap. 15 (West 2009)), as amended, the seller is not released from liability to the fund under the contributions, distributions, and withdrawals sections of the act. Accordingly, although the buyer has agreed to assume the obligations of the seller, such seller remains liable, under the act, for contributions even after a transfer of its interest unless the limited partnership agreement specifically provides for the right of the general partner to release such seller from such obligations.

Transfer to Affiliates of the General Partner

Both parties to a transfer are typically required to indemnify and hold harmless the general partner from any and all obligations that may arise from or in connection with the transfer. However, in instances where the buyer is an affiliate of the general partner, the general partner may join as a party and require the seller to make additional representations acknowledging that the buyer, as its affiliate, has access to certain information regarding the fund and its investments that differ from that disclosed to the seller in its capacity as a limited partner. Such representation may also include an agreement by the seller that the fair market value of the interest may differ from the purchase price, and that

neither the buyer nor the general partner has any obligation to provide the seller with guidance regarding the determination of fair value.

Under Delaware law, although a general partner and its affiliates that seek to purchase an investor's partnership interest are not per se required to offer the interest first to other limited partners before buying the interest, unless the limited partnership agreement provides otherwise,¹¹ they are subject to fiduciary obligations and other duties that may significantly affect any such purchase.¹²

Strategies for Raising Capital for Private Funds

As mentioned earlier, we sit here in the third quarter of 2009 facing a fundraising environment that has been negative in most private fund sectors for over a year and is the most challenging environment we have seen in over ten years. The sectors that are ascendant from a fundraising perspective, such as distressed debt and secondary funds, are rising in response to opportunities presented by the ongoing recession. There are opportunities for distressed funds in all parts of the market cycle. However, most of the money raised for these strategies in the past year is specifically targeting opportunities arising from the credit crisis-induced recession. The amount of assets currently available for investment in these strategies is larger than can be deployed in most parts of the economic cycle.

¹¹ See generally *In re Marriott Hotel Properties II Limited Partnership Unitholders Litigation (In re Marriott Hotel Properties 2)*, No. Civ.A. 14961, 2000 WL 128875 (Del. Ch. Jan. 24, 2000) (the court did not require the general partner and its affiliated buyers to offer secondary transfers of partnership interests first to limited partners, but rather found other fiduciary obligations and duties owed to limited partners).

¹² See *id.* at *18. The court held that the general partner must fully disclose to the limited partner transferring its interest all material information concerning the business and value of the partnership, and must not engage in self-interested actions to facilitate the transfer at the expense of limited partners and the partnership. The court imposed a duty on the general partner of “full disclosure of material information respecting the business and value of the partnership” in a transfer where the buyer is an affiliate of the general partner. This disclosure requirement applies to any information that is “material”—meaning there is a substantial likelihood that the limited partner transferring its interest would view the information as significant in its deliberation of the decision to sell. Further, the court held that if the transfer involves a change in control of the partnership, the general partner has a fiduciary obligation to solicit possible alternative offers and approve the transfer at the highest available price. If the transfer is involuntary (as in the case of a default by the selling limited partner), the general partner must ensure the fairness of the price.

Even as late as the end of the fourth quarter of 2008, institutional fund investors were hinting that they expected 2009-vintage investments to be superb opportunities. This belief provided significant fuel to the market for secondary fund interests over the last twelve months, as some investors bought more access to 2009-vintage investments. These beliefs, or hopes, have diminished as 2009 has worn on, with many sponsors as well as investors willing to wait for signs that the time is ripe to invest.

Traditionally heavily weighted sectors, such as buyout funds—both middle market and bulge bracket—and real estate opportunity funds, are burdened with significant undrawn capital commitments as private fund sponsors struggle to find appropriate investment opportunities. The lack of credit financing for private fund transactions has further exacerbated the problem. Fund sponsors know that taking larger equity positions in portfolio companies relative to debt will drive down returns. This puts pressure on transaction prices that sellers are not yet prepared to face. Fund investors are of two minds regarding this standoff: they are both frustrated with bearing management fees on uninvested capital, yet relieved that capital is not being called by sponsors for new investments, since they are facing their own liquidity constraints.

Additionally, many fund sponsors are kept out of the fundraising market because the funds they manage are either deploying capital so slowly that fresh capital is not required to keep investing; they have not been able to exit their existing deals—which typically supplies not only the capital that is available for subsequent funds, but the justification and validation for investors to “re-up”; the sponsors know it is an investors’ market and they do not want to be forced to cut deals and make compromises they will regret in hindsight; or a combination of all of these factors. Investors, on the other hand, are content to wait. There may be no incentive for investors, who have their own liquidity concerns, to commit capital that will remain uninvested yet bear a management fee in a market in which deal-making is so difficult to do. Moreover, investors’ concerns about access to sponsors have diminished as the supply-demand dynamic has reversed: private investment funds have seen declines in their returns along with the rest of the market in the current downturn, and thus a decline in their allure, and there are fewer investors willing or able to invest in private funds.

Issues Faced by Existing Fund Sponsors Seeking to Raise Follow-On Funds

Sponsors of existing funds that are approaching the end of their investment period or are close to full investment may face a perplexing challenge: raising more capital from an investor base that may have every reason to be satisfied with the sponsors' performance, but is nonetheless constrained by the current economic reality. In this market, nothing can be taken for granted. Despite a good track record of deploying capital effectively, avoiding major losses, and achieving favorable exits, the presence of management continuity and a cohesive team, and open communications with investors, a sponsor may still face investors seeking, among other things, justification for the rate of management fees, increased transparency, and the ability to opt out of deals. Based on our clients' experience, we believe the strategies below will yield the greatest likelihood of fundraising success:

- **Have a well-defined investment strategy.** One of investors' major complaints over the course of the last cycle is the breadth of many funds' investment mandates. Whether broad mandates lead to the breakdown of discipline is debatable. However, investors now have a clear preference for investment teams with focused experience that are tied to seeking investments within their advertised expertise.
- **Emphasize alignment of interests.** The decoupling of interests between a fund sponsor and a fund's investors can occur at many levels. For instance, the fact that the gross amount of the management fee received by a sponsor may dwarf the sponsor's expenses is an often-cited misalignment of interests. Similarly, investors want to see a fund's sponsor with significant skin in the game through a large economic commitment to the fund.

Issues Faced by New Private Fund Management Firms

The upheaval in the investment banking and private equity sectors has resulted in a swell of investment professionals who are suddenly displaced from their professional homes, sufficiently disillusioned with how their firms have fared or how their investment programs have evolved, or taken aback by the fragility of positions or situations they considered to be secure.

Others see investment opportunities that are so unique or specialized that they want to pursue them outside the bounds of a traditional private equity shop, be it an institutional environment or a privately held firm. These private equity professionals are exploring the formation of new management firms and the raising of funds in a market that is remarkably unwelcoming to start-up sponsors.

Seed Deals in the New Economy

One of the most sought-after situations for new private equity fund sponsors is the identification of seed investors. The terms “seed” and “stake” are typically used interchangeably to refer to one or another of three situations. The first is where an investor provides seed money to the sponsor and/or manager to be used to establish operations and cover costs during a fund’s marketing period. The second case is where an investor provides the capital for the sponsor’s early investments, which may or may not be rolled into a fund upon its formation. These investments may be discretionary or non-discretionary. The third case is a combination of the first two situations. Often co-investment rights or other options are attached to the seed investment. The manager draws a salary from the management fees paid on the initial investor’s capital, generally at a discount to the rate of management fees that third-party investors in the fund would pay. Most significantly, the seed investor often takes a share of the management fee and carried interest, usually through a direct investment in the manager and the general partner of the fund. The seed investor’s share of the manager’s income in recent deals we have seen has ranged between 35 and 65 percent, up from a range of 20 to 40 percent (and occasionally 50 percent) that was typical a few years ago.

These deals are exceedingly hard to find right now. Seed investors have the same liquidity constraints as other investors, and these investments are notoriously risky. The equity stake claimed by seed investors in these deals is very high and arguably does not leave enough economic incentive for the managers, according to the investment professionals and investors, who are concerned about the misalignment of interests that arises if the manager’s investment professionals do not get to keep enough of the carried interest.

New Funds: Changes in Deal Terms to Attract Capital

Even in the funds that are being raised successfully in the current climate, the negotiating leverage has shifted dramatically to investors. The most significant area where investors can, and are, flexing their muscles relates to the economics of the fund.

Management fees are being reduced across the board, and many larger investors are able to negotiate additional breaks, something to which many sponsors were resistant in the past. As noted above, investors are looking for an alignment of interests between the sponsor and the investors, and are sensitive to the perception that sponsors get rich on management fees. The downsizing that is occurring in the industry is drawing attention to the stream of management fees as well, with investors wondering whether they are bearing the costs of employees who are no longer needed or around. The scrutiny on management fees is only exacerbated by the agreements into which sponsors are sometimes entering with respect to the limited or staged deployment of capital of a fund. For example, when a sponsor agrees that it will not invest in excess of 25 percent of the capital commitments for the first twelve to eighteen months of the fund's term, an investor is more likely to ask why it is paying a fee on 100 percent of the capital commitment during that time. Never mind that even absent such an agreement, sponsors generally do not deploy 100 percent of the capital commitment at once, and rather, the investment activities of the fund are conducted throughout the typical three to six years of the fund's investment period.

Similarly, fees received by a fund sponsor or its affiliates in connection with investments (e.g., transaction, monitoring, break-up, and similar fees) are increasingly shared 80/20 between the fund and the fund sponsor, where in the past this sharing ratio was often 50/50, and in some cases there were significant exceptions to fee sharing at all. Under the 80/20 sharing arrangement, 80 percent of all such fees received by the sponsor or its affiliates would reduce the management fee payable by investors.

In addition to pressure on management fees, there have been shifts in the distribution waterfall and claw-back structures that favor limited partners. The 25 percent carry historically charged by a few marquee sponsors, including TA Associates and Providence Equity Partners, has generally

been reduced to the market 20 percent rate amidst the pressure on fees. There have also been a few instances of reductions below the 20 percent standard. Dow Jones Private Equity Analyst reported in its July 30, 2009, edition that Blackstone Group Inc. has set the carried interest on its debut infrastructure fund at 15 percent over an 8 percent hurdle rate compared to the 20 percent carry on its traditional buyout funds, and KKR has set carry at 10 percent on its debut infrastructure fund. Furthermore, large investors are more inclined to negotiate special reduced carry deals in exchange for their commitment, and hurdle rates and preferred return rates are increasing in some cases.

Although in recent history many sponsors of large buyout funds received carry distributions on a deal-by-deal basis, there has been significant resistance to this structure (and it is virtually impossible for a first-time sponsor) given the increased possibility of an over-distribution to the general partner and a claw-back situation. The most typical alternative to a deal-by-deal distribution waterfall is for the proceeds from the disposition of investments to be returned to investors on an “all capital back” basis. Under this structure, each investor receives 100 percent of the capital it has contributed to the fund, and only then is the general partner entitled to any carried interest distributions.

There has also been pressure on the general partner claw-back provisions that protect the fundamental 80/20 deal between the fund’s investors on the one hand, and the fund’s general partner on the other hand. Additional scrutiny is being placed on the underlying agreements whereby the carry recipients guarantee the general partner’s claw-back obligation. Investors are increasingly requesting that these guarantees be provided on a joint and several basis (rather than a several basis) to be fully protected in the case of a claw-back situation. Guaranteeing a claw-back on a joint and several basis means an investor can pursue a single member of the management team for the entire claw-back obligation, rather than going after each member for their share of the claw-back. In such a case, the individual who paid the claim would then have a right to make a claim against each other member of the management team for a *pro rata* share of the liability. Other mechanisms investors are requesting to lessen their exposure to a claw-back situation include (i) requiring that general partners further secure their claw-back obligation by depositing all or a

portion of carry received in an escrow account, and (ii) instituting interim (e.g., annual) claw-back calculations such that a general partner may be required to make claw-back payments at specific times during the life of the fund rather than only at the time of dissolution of the fund.

Legal and Contractual Strategies and Hurdles in the Face of Fundraising Challenges

Addressing Limited Partner Hot-Button Issues

In addition to the pressure on fees and carry discussed above, and most likely in response to the Madoff scandal and other recent cases of fraud in the investment industry, investors across the board are becoming increasingly sensitive to affiliate transactions, conflicts of interest, and fiduciary duties, and generally paying particular attention to the sponsor's authority and discretion to act on behalf of the fund. Examples of areas where investors have demonstrated a greater scrutiny include the ability of a sponsor to do any of the following: (i) engage in affiliate transactions, (ii) divert from the stated investment strategy, (iii) allocate investment opportunities away from the fund, (iv) handle pending or actual investor defaults, and (v) engage in any other activity outside of the express provisions in the fund documents. Sponsors have been and will continue to be receptive and responsive to these concerns, and we are seeing greater limitations on a general partner's discretion in these areas. Sponsors are increasingly willing to subject themselves to greater oversight by the fund's advisory committee and are agreeing to obtain consent in order to engage in many other activities, such as those listed above.

Tax and Regulatory Hurdles for Sponsors

Tax Proposals

Several recent legislative proposals that would alter the U.S. taxation of private equity funds and the fund sponsors have attracted significant attention from fund sponsors and their counsel. One legislative proposal would treat carried interest received by a fund sponsor as ordinary income, regardless of the underlying character of the income that generated the carried interest. Another proposal would treat subject funds organized as

non-U.S. corporations to full U.S. corporate income tax if the investment activity of the fund is managed from within the United States.

With respect to the proposal to tax carried interest as ordinary income, press articles have suggested that private investment fund sponsors should restructure the way their “carried interest” is currently paid in order to avoid or lessen the impact of potential changes in tax law.

One approach that has been suggested would require limited partners in funds (or perhaps the fund itself) to loan the carried interest recipient (typically the general partner of a fund), on a non-recourse basis, an amount equal to the carried interest percentage of the fund’s capital (typically 20 percent of capital). The fund sponsor would then invest into the fund the loaned capital. The concept is that the carried interest would be converted from a profits interest, earned on limited partner capital into a return on the fund sponsor’s invested capital (loaned to it by the limited partners).

A second approach that has been proposed is that the fund sponsor holds its carried interest in the investment fund through an offshore corporation. Typically, this corporation would be located in a low- or no-tax jurisdiction. There are many variations on this structure, some of which require minority U.S. ownership to avoid another set of punitive tax rules applicable to so-called “controlled foreign corporations.”

A third approach would require payment of carried interest as a fee, rather than as an allocation of profits. Such a structure could result in deferral of tax, and in certain unique circumstances retention of capital gains treatment for carried interest.

Each of the approaches outlined above would require significant changes to funds’ operating procedures (including, in some cases, relocation outside the United States of significant personnel), or would require fund sponsors to keep cash proceeds from the carried interest outside the United States for a significant period of time. Further, it is important to note that certain versions of the legislative proposals regarding the tax treatment of carried interest have taken note of the approaches commentators have suggested to circumvent treatment of carried interest as ordinary income. These legislative proposals would render each of the approaches suggested to

avoid ordinary income tax treatment (other than the proposal to move all meaningful general partner operations outside the United States) ineffective.

It would seem that implementing any specific approach currently to mitigate the adverse tax effects of future legislative change would be premature, particularly when, as of now, it is not clear what the terms of such prospective legislative change will be, if any. Instead, it would seem prudent to provide the sponsor of a fund with more general flexibility to amend the structure of the fund and the provisions of fund documents to meet such potential future legislative or regulatory changes. Such authority to amend the fund documents would likely be subject to a caveat that the fund sponsor would not be entitled to modify the fund structure or the terms of fund documents if such modification could or would adversely affect limited partner investors in the fund, either on a pre-tax or after-tax basis.

With respect to the proposal to tax funds organized as non-U.S. corporations as U.S. corporations if the investment activity of the fund is managed from within the United States, it appears uncertain, and perhaps doubtful, whether this proposal would be enacted as law. If the proposal were enacted, each fund that would be affected by such proposal would need to analyze the level of the fund's management activities that could reasonably be moved outside the United States in order to avoid the fund becoming subject to U.S. corporate income tax.

Regulatory Proposals

It appears certain that private funds and advisers to private funds will be subject to additional regulation in the upcoming months. Regulation of private funds and their advisers has been discussed at length recently in Congress, state legislatures, and among many industry participants and commentators, as the financial crisis has brought intense scrutiny to the industry. On June 17, 2009, the Obama Administration unveiled a comprehensive plan to revamp the U.S. financial regulatory system—“Financial Regulatory Reform—A New Foundation: Rebuilding Financial Supervision and Regulation” (the Plan). The Plan's proposals have significant implications for private funds and their advisers, and reflect the administration's reaction to the outcry from many quarters for their

increased regulation. In addition, on July 15, the administration sent to Congress a legislative proposal—the “Private Fund Investment Advisers Registration Act of 2009” (the Fund Proposal)—that, if passed, would enact many of the private fund recommendations included in the Plan. As discussed below, the Plan, on the heels of numerous legislative efforts to regulate private funds, includes recommendations for: (i) private fund adviser registration; (ii) a variety of disclosure and record-keeping requirements with respect to private funds and the potential for strict capital, liquidity, and risk management standards reserved for firms whose failure could pose a threat to financial stability; (iii) harmonization between the Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission (CFTC); (iv) a fiduciary duty obligation for broker-dealers providing investment advice; and (v) global coordination of private fund regulation. In addition to the Fund Proposal (discussed below), three bills have been introduced in Congress this year that would also compel the majority of private fund advisers to register with the SEC:

- The “Hedge Fund Adviser Registration Act of 2009,” H.R. 711, 111th Cong. (2009), introduced in the U.S. House of Representatives on January 27, 2009, would require most private investment advisers to register by eliminating the fifteen client *de minimis* exception in Section 203(b)(3) of the Advisers Act (15 U.S.C. § 80b-3 (2006)),¹³ subject to the \$30 million *de minimis* threshold of the Advisers Act.
- On January 29, 2009, the “Hedge Fund Transparency Act,” S. 334, 111th Cong. (2009), was introduced by Senators Chuck Grassley (R-Iowa) and Carl Levin (D-Michigan). The act seeks to cause private funds of more than \$50 million to register as investment companies under the Investment Company Act, provide significant annual public disclosures to the SEC, and maintain books and records in accordance with SEC rules and cooperate with the SEC on requests for information.

¹³ Section 203(b)(3) exempts from registration under the Advisers Act any investment adviser who, during the course of the preceding twelve months, has had fewer than fifteen clients and does not hold himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company.

- The “Private Fund Transparency Act of 2009,” S. 1276, 111th Cong. (2009), which is the bill most closely aligned with the Plan’s private fund proposals, was introduced on June 16, 2009, by Senator Jack Reed (D-Rhode Island). The act would, by limiting the fifteen client *de minimis* exception in Section 203(b)(3) (15 U.S.C. § 80b-3) of the Advisers Act to “foreign private advisers,”¹⁴ require all other advisers that manage more than \$30 million in assets to register as investment advisers with the SEC (the remaining smaller funds would fall under state oversight), and impose certain confidential¹⁵ disclosure and recordkeeping requirements.

The Fund Proposal, although not yet formally introduced in Congress, includes a variety of proposed amendments to the Advisers Act that are similar to those included in the Private Fund Transparency Act and the private fund recommendations included in the Plan. The Fund Proposal would require almost all U.S.-based investment advisers with more than \$30 million in assets under management to register with the SEC by eliminating the fifteen client *de minimis* exception in Section 203(b)(3) of the Advisers Act (15 U.S.C. § 80b-3).¹⁶ In place of the former fifteen-client exception,

¹⁴ The definition of “foreign private advisers” would be added to the Advisers Act. A foreign private adviser is defined in the PFTA as any investment adviser who (a) has no place of business in the United States; (b) during the preceding twelve months has had (i) fewer than fifteen clients in the United States and (ii) assets under management attributable to clients in the United States of less than \$25,000,000, or such higher amount as the SEC may, by rule, deem appropriate in accordance with the purposes of this title; and (c) neither holds itself out generally to the public in the United States as an investment adviser, nor acts as an investment adviser to any investment company registered under the Investment Company Act or a company that has elected to be a business development company pursuant to Section 54 of the Investment Company Act (15 U.S.C. § 80a-53 (West 2009)) and has not withdrawn its election.

¹⁵ The PFTA provides, “[n]otwithstanding any other provision of law, the [SEC] shall not be compelled to disclose any supervisory report or information contained therein required to be filed with the [SEC] under [the PFTA],” provided however, that “[n]othing in this subsection shall authorize the [SEC] to withhold information from Congress or prevent the [SEC] from complying with a request for information from any other Federal department or agency or any self-regulatory organization requesting the report or information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action brought by the United States or the [SEC].”

¹⁶ Section 203A of the Advisers Act (15 U.S.C. § 80b-3a (2006)) provides that investment advisers with less than \$25 million in assets under management may not register with the SEC. Rule 203A-1 increased this threshold to \$30 million, and

the Fund Proposal would create a new exemption for a “foreign private adviser” that mirrors the definition in the Private Fund Transparency Act, as described above. The term “client” in the Advisers Act has been historically interpreted to mean the private funds advised by the manager, and not the investors in the funds.¹⁷ However, the Fund Proposal clarifies the SEC’s rulemaking authority to include the ability to determine the new reporting requirements and related definitions, and to ascribe different meanings to terms used in different sections, specifically mentioning the term “client.” This may be an attempt to reverse the 2006 holding by the U.S. District Court for the D.C. Circuit in *Goldstein v. SEC*, 451 F.3d 873 (D.C. Cir. 2006), that struck down a rule by the SEC that interpreted “client” as each of the underlying investors of certain funds with redemption rights, rather than the fund itself, which interpretation would have had the effect of requiring most hedge fund advisers to register with the SEC. Any action taken by the SEC with respect to the meaning of “client” may be particularly sensitive, however, considering that the Fund Proposal would also remove the provision in Section 210 of the Advisers Act (15 U.S.C. § 80b-10 (West 2009)) that prohibits any requirement to disclose the identity of or information about an adviser’s clients and could have further implications on the nature of the sponsor’s fiduciary duties to its clients.

The Fund Proposal also gives the SEC the authority to require registered advisers to submit reports to the SEC regarding the private funds they

essentially made SEC registration optional for advisers with assets under management between \$25 million and \$30 million, by stating that “[i]f the State where you maintain your principal office and place of business has enacted an investment adviser statute, you may register with the [SEC] if you have assets under management of at least \$25,000,000 but less than \$30,000,000, as reported on your Form ADV.”

¹⁷ The Fund Proposal would also eliminate, for any adviser that manages the newly defined “private fund,” (i) the intrastate exemption from registration available to an investment adviser whose clients are all residents of a single state and who does not furnish advice or issue analyses or reports with respect to securities listed on any national securities exchange, and (ii) the exemption from registration available to an investment adviser that is registered with the CFTC as a commodity trading adviser whose business does not consist primarily of acting as an investment adviser and that does not act as an investment adviser to any registered investment company. A “private fund” is defined as an investment vehicle that is excepted from the definition of “investment company” under Sections 3(c)(1) or 3(c)(7) of Investment Company Act (15 U.S.C. § 80a-3 (2004)) and is either organized under the laws of the United States or has 10 percent or more of its outstanding securities held by U.S. persons.

advise that would include assets under management, use of leverage, counterparty credit risk exposures, trading and investment positions, and other information, in consultation with the Federal Reserve, deemed necessary or appropriate in the public interest and for the protection of investors or for the assessment of systemic risk. The SEC would be authorized to make such reports available to the Federal Reserve and the Financial Services Oversight Council contemplated by the Plan for the purpose of assessing systemic risk and determining if a private fund should be designated a “Tier 1 FHC.”¹⁸ Registered advisers would be subject to periodic and special examinations by the SEC to monitor their compliance with the record-keeping requirements. The reports submitted to the SEC are to be “confidential,” and therefore not subject to the application of the Freedom of Information Act, Pub. L. No. 89-487, 80 Stat. 250 (1966) (codified at 5 U.S.C. § 552). However, the Fund Proposal would also permit the SEC to require a registered adviser to provide certain reports, records, and other documents to investors, prospective investors, counterparties, and creditors of any private fund it advises.

The Fund Proposal also provides that within six months after it is passed, the SEC and the CFTC, after consultation with the Federal Reserve, shall jointly promulgate rules to establish the form and content of reports required to be filed with the SEC and the CFTC by investment advisers that are registered both under the Advisers Act and the Commodity Exchange Act.

Based on the Plan, the Fund Proposal, and the various legislative proposals that have been introduced in Congress, it appears certain that increased regulation of private funds and private fund advisers is on the horizon. In light of its similarity to the Plan and the PFTA, and because the Obama administration itself proposed it, the Fund Proposal will likely take precedence over the prior three private fund bills that have been formally introduced in Congress. It is important to note, however, that the legislation and regulations necessary to implement the Plan’s private

¹⁸ As discussed in the Plan, Tier 1 FHCs would be required to meet the qualification requirements for FHC status (as revised by the Plan), including strict capital and liquidity requirements, a prompt corrective action regime upon declining capital levels, risk management practices, public disclosure requirements, restrictions on non-financial activities, and rapid resolution plans in the event of severe financial distress.

fund recommendations, a crucial component of which will be the allocation of sufficient resources to the appropriate regulators, have yet to be enacted.

The Obama Administration is pushing for the Plan to become law before the end of 2009, and in light of the fact that the administration has already sent to Congress a number of proposals that would implement some of the Plan's recommendations,¹⁹ such a bold timeline may not be far off.

In addition to Congress enacting legislation that would require sponsors of private equity funds to register as investment advisers under the Advisers Act, the SEC is also considering exacting rules that would impact the activities of private fund sponsors. On August 3, 2009, for example, the SEC proposed a rule intended to curtail "pay to play" practices by investment advisers who seek to manage money for state and local governments.²⁰ SEC Chairman Mary Schapiro mentioned the proposal in late April 2009, after New York Attorney General Andrew Cuomo unsealed indictments following a two-year investigation into alleged kickbacks related to the use of unregistered placement agents for the \$122 billion New York State Common Retirement Fund. The proposed rule would prohibit an investment adviser and certain of its executives and employees from (a) coordinating or asking another person or political action committee to make (i) a contribution to an elected official, or candidate for the official's position, who can influence the selection of the adviser or (ii) a payment to a political party of the state or locality where the adviser is seeking to provide advisory services to the government; (b) paying a third party, such

¹⁹ In addition to the July 15 legislative proposal noted above, the administration's legislative proposals regarding the Plan include: (i) legislation that would create the Consumer Financial Protection Agency (sent to Congress on June 30, 2009), (ii) legislation that would establish a fiduciary duty for broker-dealers providing investment advice (sent to Congress on July 10, 2009), (iii) legislation regarding executive compensation and "say on pay" (sent to Congress on July 16, 2009), (iv) legislation that would increase the regulation of credit rating agencies (sent to Congress on July 21, 2009), (v) legislation that would create the Financial Services Oversight Council (sent to Congress on July 22, 2009), (vi) legislation that would create a National Bank Supervisor and the Office of National Insurance (sent to Congress on July 23, 2009), and (vii) legislation that would increase regulation of over-the-counter derivatives markets (sent to Congress on August 11, 2009).

²⁰ Political Contributions by Certain Investment Advisers, Investment Advisers Act Release No. 2,910, 17 C.F.R. Part 275 (proposed Aug. 3, 2009). Comments on the proposed rule are due to the SEC by October 6, 2009.

as a solicitor or placement agent, to solicit a government client on behalf of the investment adviser; or (c) directing or funding contributions through third parties such as spouses, lawyers, or affiliated companies, if that conduct would violate the proposed rule were the adviser to do so directly. Under the proposed rule, an investment adviser who makes a political contribution to an elected official in a position to influence the selection of the adviser would be barred for two years from providing advisory services for compensation to the particular government entities for which triggering contributions have been made.²¹

Conclusion

During this turbulent period, the private equity fund community has changed its industry norm. As many traditional strategies have fallen out of favor, sponsors have looked more to strategies designed to take advantage of the current credit crisis. Additionally, there has been tremendous growth in the secondaries market and in annex funds that compensate or otherwise address issues related to the lack of liquidity in the market and among investors. Furthermore, sponsors have been forced to reassess their relationships with their investors, who are themselves grappling with an uncertain economic climate.

In the coming months, sponsors will have to continue to be creative in the ways they attract capital, and they will have to be particularly attentive to the myriad of regulatory and tax changes that are sure to provide the private funds community with yet another jolt to business as usual. No doubt, we will soon look back on this period as a time when the industry as a whole rose to the challenges presented by the economic climate by demonstrating creativity and flexibility, and by rapidly adapting to changed circumstances.

²¹ The *de minimis* provision in the proposed rule would permit an executive or employee of an adviser to make contributions of up to \$250 per election per candidate if the contributor is entitled to vote for the candidate.

David Goldstein is global co-head of the investment funds group at White & Case LLP. He focuses on the establishment and representation of private investment funds, including both domestic and international private equity and hedge funds. His clients include merchant banking and leveraged buyout funds, real estate opportunity and value funds, international real estate funds, emerging markets funds, well-established funds and managers based outside the United States investing in non-U.S. markets, first-time funds of high-quality emerging managers, fund sponsors in structuring their governance and compensation arrangements, and investors in alternative assets. Among his clients are Gavea Investimentos Ltd., Littlejohn & Co., Indicus Advisors, Asia Debt Management Ltd., Brown Bear Capital Partners, and Probitas Partners.

Scott Berger serves as the global head of the real estate practice group at White & Case LLP. He represents equity investors, investment funds, developers, lenders, and owners in a broad range of real estate transactions throughout the United States and abroad. These include joint ventures and capital market transactions, financings, and the acquisition, development, leasing, and disposition of all types of commercial, hospitality, mixed-use, industrial, and residential properties. His practice includes advising clients such as the Starwood Capital Group, Groupe du Louvre, Meridian Capital, and GID Investment Group.

Monica K. Arora is a partner in the investment funds group at White & Case LLP. She has extensive experience advising financial institutions, investment banks, and private equity firms as sponsors of and investors in private investment funds spanning numerous industries in the United States, as well as in Asia, Europe, and the Middle East. She also has significant experience advising sponsors and investors in connection with secondary transactions involving private investment funds, has advised financial institutions and private fund sponsors in structuring carried interest and employee investment programs, and has provided regulatory guidance to a number of private fund sponsors on investment adviser registration and investment company matters. Recent clients include Hastings Fund Management, Macquarie Capital Funds, Landmark Advisors, and Tenaska Capital Management.

John T. Lillis is a partner in the tax group at White & Case LLP. He is involved in a broad range of transactions regarding tax issues. He structures and analyzes the cross-border tax issues in investment funds formation and investment and operating joint ventures to achieve tax efficiencies from a U.S. and non-U.S. tax perspective. In addition, he structures and negotiates asset and stock acquisitions by investment funds and other clients to determine historic tax issues and the tax treatment of the acquired

entities. Recent clients include Starwood Capital Group, Nordic Capital, Indicus Advisors, and Saudi Aramco.

Jeremy M. Naylor is a partner in the tax group at White & Case LLP. He has a general practice in domestic and international tax planning for corporate and partnership transactions, with a focus on the economic and tax aspects of private equity, including the representation of both sponsors of private equity funds and institutional investors. He also advises institutional investors with respect to their investments in domestic and international private investment funds, including venture capital, buyout, real estate, and hedge funds. Recent clients include Starwood Capital Group, Landmark Advisors, Nordic Capital, and several large institutional investors.



ASPATORE

www.Aspatore.com

Aspature Books, a Thomson Reuters business, exclusively publishes C-Level executives (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. C-Level Business Intelligence™, as conceptualized and developed by Aspature Books, provides professionals of all levels with proven business intelligence from industry insiders—direct and unfiltered insight from those who know it best—as opposed to third-party accounts offered by unknown authors and analysts. Aspature Books is committed to publishing an innovative line of business and legal books, those which lay forth principles and offer insights that when employed, can have a direct financial impact on the reader's business objectives, whatever they may be. In essence, Aspature publishes critical tools for all business professionals.

Inside the Minds

The *Inside the Minds* series provides readers of all levels with proven legal and business intelligence from C-Level executives and lawyers (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. Each chapter is comparable to a white paper or essay and is a future-oriented look at where an industry, profession, or topic is heading and the most important issues for future success. Each author has been selected based upon their experience and C-Level standing within the professional community. *Inside the Minds* was conceived in order to give readers actual insights into the leading minds of top lawyers and business executives worldwide, presenting an unprecedented look at various industries and professions.



ASPATORE