
Hedge Fund Breakfast Seminar:
Market and Regulatory Trends
KIRKLAND & ELLIS LLP
A LAW FIRM SERVING GLOBAL CLIENTS
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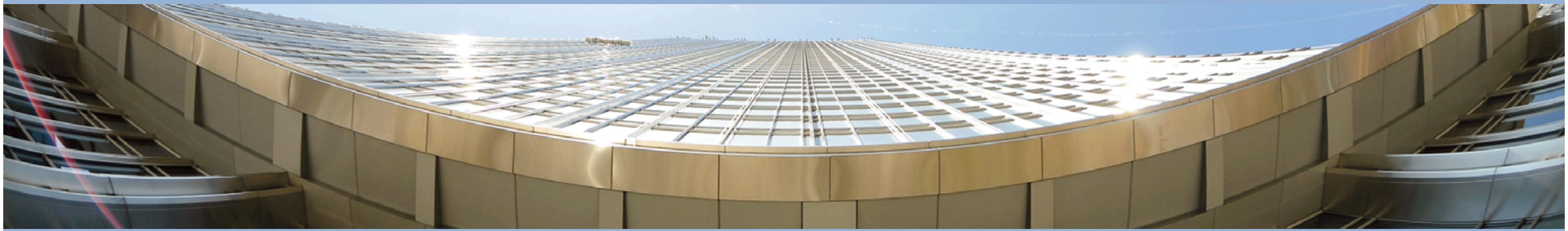

Current Enforcement Trends

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Current Enforcement Trends

- Structural and Policy Changes at the SEC
  - Specialization: Asset Management Unit
- Dodd-Frank SEC Enforcement Provisions
  - Expanded Secondary Liability
  - Jurisdiction Over Foreign Securities Transactions
  - Whistleblower Bounty Program
- Aggressive Enforcement Environment
  - Focus on Wall Street Trading Activity
  - Expert Network Cases
  - “New” Investigative Techniques

SEC ENFORCEMENT STRUCTURAL AND POLICY CHANGES

Structural and Policy Changes

- A Swifter Enforcement Division
  - Eliminating an entire layer of management and restricting the use of tolling agreements.
  - Delegating authority to obtain formal orders and issue subpoenas.
  - Streamlining the Wells process and other processes.
- Increased Credit for Cooperation
  - Formalized policy for into entering cooperation agreements with individuals.
  - Utilizing DOJ-style deferred-and non-prosecution agreements.
  - Expedited process for securing criminal immunity requests.

Enhanced Specialization

- Five Specialized Units
  - ***Asset Management Unit***: Largest of new units; focus on investment advisers, investment companies, hedge funds and private equity funds..
  - ***Market Abuse Unit***: Large scale market abuses and complex manipulation schemes by institutional traders and market professionals and others.
  - ***Structured and New Products Unit***: Complex derivatives and financial products.
  - ***Foreign Corruption Unit***: Focus on new approaches to identifying violations; more cooperation with foreign counterparts.
  - ***Municipal Securities and Public Pension Unit***: Offering and disclosure issues, tax, or arbitrage driven activity, under-funded liability, and pay to play.
- Asset Management is the Largest Unit with the Highest Profile

Asset Management Unit Priorities

- Potential Enforcement Cases
  - False Disclosures
  - Valuation
  - Portfolio Performance
  - Safekeeping of Assets
  - Redemption Issues
  - Side Pockets, Lock-Ups
  - Selective Disclosures
  - Record Keeping
  - Failure to Supervise
  - Misappropriation
  - Insider Trading
  - Due Diligence
  - Conflicts of Interest
  - Affiliate Transactions
  - Placement Agents
  - Complex Derivatives
  - Municipal Securities
  - Public Pension Fund Investments
  - Market Manipulation
  - Improper Short Selling
  - Rumors

DODD-FRANK SEC ENFORCEMENT PROVISIONS

Dodd-Frank SEC Enforcement Provisions

- Expanded Secondary Liability
  - Reduces required intent for aiding and abetting liability to a showing of "recklessness" (as opposed to "knowingly").
  - Adds aiding and abetting liability under the Securities Act, Investment Company Act, and the Investment Advisers Act.
  - Clarifies SEC's authority to bring "control person" claims.

Dodd-Frank SEC Enforcement Provisions

- Jurisdiction Over Foreign Securities Transactions
  - Attempts to grant SEC jurisdiction over foreign transactions if "significant steps" taken in the U.S. to further the violation, or if foreign misconduct had a "foreseeable substantial effect" in the U.S.
  - Passed in response to Supreme Court's June 2010 "f-cubed" case; however, language creates some ambiguity whether the provision accomplishes that objective.

Dodd-Frank SEC Enforcement Provisions

- Whistleblower Bounty Program
  - Mandatory cash awards of 10% to 30% of total sanctions recovered by government (greater than $1 million) as a result of the whistleblower's assistance.
  - Rewards voluntary submission of original information
    - Derived from independent knowledge/analysis
    - Must not be legally obligated to provide information
  - Broad eligibility: employees, analysts, suppliers, customers.
  - Concern for potential impact this program could have on compliance policies and procedures designed to promote internal self-reporting.

AGGRESSIVE ENFORCEMENT ENVIRONMENT

Aggressive Enforcement Environment

- Focus on Wall Street Trading Activity
  - ***Galleon***, Lit. Rel. Nos. 21255, 21284, 21397 (Jan. 29, 2010) (S.D.N.Y.) Sources of the tips included wide array of professionals exposed to confidential information: Senior company executives, Moody's rating analyst (working on a deal for Blackstone), outside investor relations consultant, McKinsey consultant, and a hedge fund consultant.
  - ***Cutillo/Santarlas***, Lit. Rel. Nos. 21283, 21332 (Dec. 10, 2009) (S.D.N.Y.) "Octopussy" insider trading ring; tips originated with 2 associates at Ropes & Gray, counsel to private equity firms (Blackstone, Silver Lake, Bain, and TPG), in exchange for kickbacks.

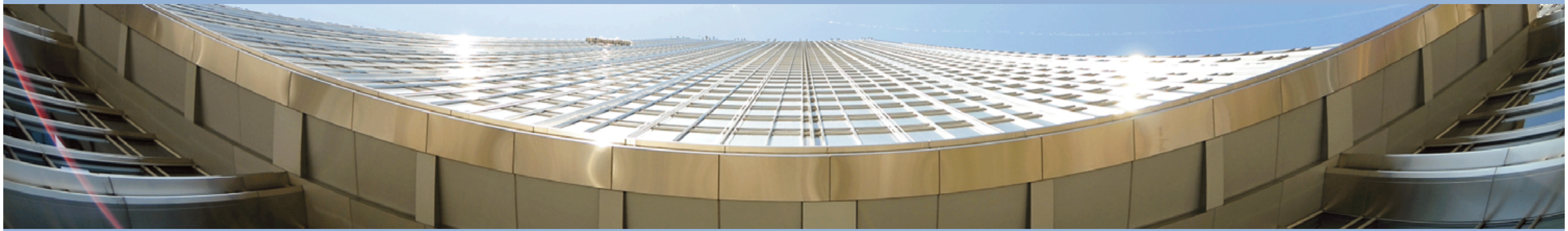
Expert Network Cases

- Expert Network Cases
  - Criminal investigation by U.S. Attorney's Office in Manhattan and the SEC's Enforcement Division into unlawful exchange of material, nonpublic information between industry "experts" and market professionals, and associated trading. See Department of Justice Press Releases dated Nov. 24, Dec. 16, Dec. 29, 2010, and February 8, 2011.
  - Parallel SEC actions filed on February 3 and 8, 2011.
  - These prosecutions raise very difficult issues regarding what is acceptable conduct on the part of hedge funds, and to what lengths funds and their employees must go to insure that they are not trading while in possession of material, nonpublic information.

Old Techniques; New Uses

- "Mob" and "Drug Cartel" Techniques Applied to Insider Trading
  - Telephone Wiretaps
  - Confidential Informants Taping Calls
  - "Wired" Cooperating Witnesses
- Additional Charges Relating to Obstruction of Justice and Destruction of Evidence

QUESTIONS?



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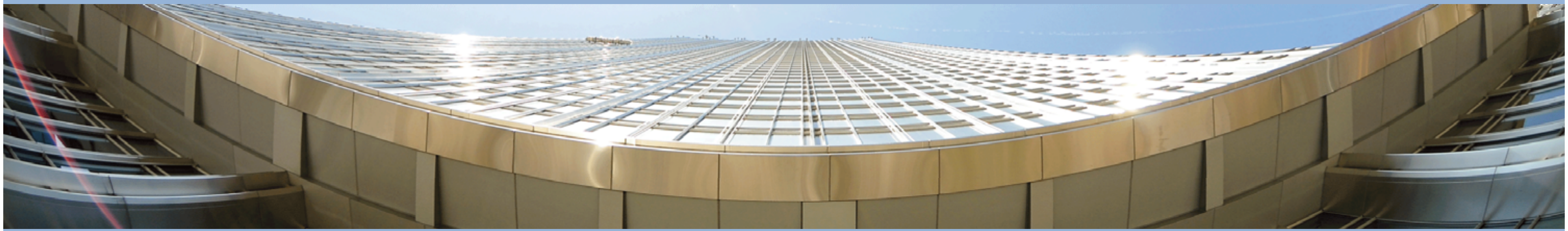

Market and Regulatory Trends

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Market and Regulatory Trends

- Market Trends
- Dodd-Frank Act Changes
- Form PF
- SEC "Pay to Play" Rule
- State Lobbyist Restrictions
- Foreign Corrupt Practices Act
- AIFM Directive
- The Volcker Rule
- Derivatives Update

MARKET TRENDS

2011 Hedge Fund Market

- 2011 Looks Bright for the Hedge Fund Industry
  - Assets surged by $149 billion in Q4 2010 when the typical fund was up 5.5%. This puts total industry assets at $1.917 trillion, slightly below the all-time high of $1.93 trillion set in Q2 2008.
    - Altogether, investors poured in $13.1 billion in net new capital to hedge funds in the fourth quarter, pushing total 2010 net inflows to $55.5 billion, the highest one-year sum since 2007.
  - Capital inflows across a range of hedge fund investor segments, including endowments, foundations, and fund of funds will climb in 2011 as the liquidity problems generated by the crash of 2008 fade into the rearview mirror.
  - Investors have also begun to warm up to smaller and mid-size funds, another indication that they are willing to take more risk in 2011 with hedge funds:
    - With funds managing more than $150 million in assets required to register by July, fund flows to smaller and mid-size portfolios could pick up as the year progresses.
  - Overall, the number of new hedge fund launches is set to rebound in a large way this year, making 2011 the best year for hedge fund launches since 2007.

Sources: Hedge Fund Research, Inc.; “Hedge Fund Assets Surge to Near Record High,” Institutional Investor, 01/19/11; “Hedge Fund Industry Set to Surge in 2011,” Advanced Trading, 01/06/11.

Market Trends - Compensation Terms

- Crisis caused pressure on management fees (historically 1.5 – 2.0%) and, to a lesser extent, on incentive compensation (historically 20%)
- Fundraising pressure, and the concurrent pressure to offer lower fees, seems to have lifted for larger managers recently, although not for smaller managers
- Historical performance fee structures have been scrutinized by institutional investors because many paid significant performance fees in prior years despite negative returns on an aggregate multi-year basis
  - This has led to demands — especially in managed account type structures — for multi-year performance measurement periods, clawbacks and similar features

Market Trends - Compensation Terms

- Recent modifications to performance compensation structures include:
  - Hurdle or preferred return over a benchmark (fixed or index-based)
  - Modified (a.k.a. “Lone Pine”) HWM
  - Multi-year performance measurement period (less common in commingled funds)
- Most performance allocation structures involving multi-year measurement periods or clawbacks raise tax considerations

Market Trends - Lockups and Redemptions

- Generally investors are demanding shorter lockup periods, but some — especially institutional investors with longer investment horizons — are willing to accept longer lockup periods for lower fees
  - By some estimates, almost 60% of investors would be unwilling to lockup capital for more than one year*
  - Longer lockups appear to be more tolerable among U.S. investors than non-U.S. investors*
  - Investors with strong liquidity needs, such as funds of funds and family offices, also seem to be willing to accept a "soft" lockup (*i.e.* subject to a redemption fee) where a "hard" lockup would be unacceptable*
- The overwhelming investor preference, by a more than 2 to 1 margin, is for quarterly or monthly redemption after lockup period*
  - Assuming that the underlying investment program can support it

* DB 2010 Survey

Market Trends - Lockups and Redemptions

- However some institutional investors are seeking, or are more tolerant of, longer lockup periods for funds with long-term investment theses
  - For example, certain distressed debt funds, other credit funds, event driven funds and activist funds
  - This deters early redemptions that may be harmful to the overall fund
- Thus, funds’ redemption terms continue to vary across the industry, depending on investment program and targeted investor base

Market Trends - Gates

- During the crisis many funds put up gates and pressure is now to remove gates or apply them at a higher threshold level (*e.g.*, 25% or more as opposed to 25% or less pre-crisis)
- Funds that actually invoked gates during the crisis have found that this has had a negative, although not fatal, impact on fundraising
  - Approximately one-third of investors expressing a reluctance to invest in such funds*

* DB 2010 Survey

Market Trends - Gates

- Most gates were “first come, first serve”
  - Skewed the incentive for investors to put redemption requests in at the first sign of trouble to maintain a higher priority over later redeemers
- More funds than in previous years have moved to apply gates at the investor level (*i.e.*, on an investor by investor basis)
  - Mitigates skewed incentives
  - But, this is less popular with smaller investors, who might not otherwise be gated if the gate were to be applied at the fund level
- Other new and creative structures are emerging to avoid skewed incentives and encourage investors not to redeem quickly
  - Fund-level gates with early and later redeemers receiving equal priority
  - Soft investor-level gates with redemption fees

Market Trends - Side Pockets

- Generally harder to include in newly-launching funds unless justified by investment program
- Most new funds that include side pockets are limited to 15% or less of NAV at time of investment, as compared to higher average levels pre-crisis (20% to 25%)
- A minority of funds that are permitted to use side pockets offer investors the ability to opt out (similar to fund terms at the advent of side pockets)
  - However, can raise issues: *e.g.*, does the opt-out apply to all side pocketed investments, including investments that are side pocketed as a result of an impairment?

Market Trends - Side Pockets

- Institutional investors generally recognize that side pockets are appropriate in certain cases, but are stressing:
  - Clearly stated and consistently applied side pocket policy (including how fees and HWM are calculated and types of investments eligible to be side pocketed)
  - More specific mechanics for side pockets in partnership agreements

Market Trends - Increased Investor Diligence

- Investors are more cautious due to Madoff-driven concerns and poor performance in recent periods
- Investors are conducting more diligence on hedge fund managers prior to investing, including:
  - Scrutinizing prior performance (including the generation of positive alpha)
  - Reviewing prior use of gates, history of suspending redemptions and liquidation of prior funds (in order to reset HWM)
  - Requiring managers to respond more frequently to detailed due diligence questionnaires
  - Hiring outside counsel to review (and in some cases negotiate) fund documents
  - Hiring outside investment consultants to assist in background due diligence

Market Trends - Increased Investor Diligence

- Investors also placing greater emphasis on reputable third-party service providers, including:
  - Auditors
  - Administrators
  - Custodians
  - Prime brokers
  - Outside attorneys
  - Independent directors (for offshore or master funds in corporate form)

DODD-FRANK ACT CHANGES

Dodd-Frank Act Changes

- Many Private Fund Managers, Including Hedge Fund Managers, Have Relied on Longstanding Exemptions from U.S. Federal and State Investment Adviser Registration
- Last July Congress Enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")
  - Dodd-Frank Act deals mainly with banking and derivatives reform, but also includes key changes for private fund managers
  - Will require most larger private fund managers to be registered with SEC as investment advisers by July of this year
  - Fund managers should consider filing for SEC registration by late April or early May 2011 to ensure registration by the July deadline

Dodd-Frank Act Changes

- Existing Federal Exemption Eliminated
  - Dodd-Frank Act eliminates current federal fewer-than-fifteen-client exemption from IA registration effective July 21, 2011
- New Limited Federal Exemptions
  - Smaller advisers: generally, any U.S. fund manager with clients other than private funds (*e.g.*, managed accounts) and less than $100M AUM (up from prior $25M AUM)
    - States regulate the manager under this exemption, and may require registration
  - Mid-sized advisers to private funds: generally, any fund manager that solely manages private funds (*i.e.*, §3(c)(1) and §3(c)(7) entities) with less than $150M aggregate AUM in the U.S. will be exempt under new SEC rulemaking*

*A U.S. private fund manager with $100M AUM (but less than $150M AUM in the U.S.) solely in private funds may (but is not required to) register with the SEC as an investment adviser.

Dodd-Frank Act Changes

- Modifies Accredited Investor/Qualified Client Standards
  - Excludes a natural person's primary residence from the calculation of the Reg D accredited investor $1M net worth standard, effective July 21, 2010
    - SEC proposed rule on January 25, 2011 requiring that "the value of the primary residence" be determined by subtracting from the estimated fair market value of the property the amount of debt secured by the property, up to the estimated fair market value of the property.
  - Requires that the SEC adjust two financial tests for inflation:
    - Advisers Act qualified client tests for performance-based fees, currently $1.5M net worth/$750,000 AUM, by July 21, 2011 (and every five years thereafter)
      - SEC may extend "grandfathering" of existing investors who do not meet new qualified client standard
    - Reg D accredited investor natural person $1M net worth standard, but not until July 2014 (and every four years thereafter)

Dodd-Frank Act Changes

- Adopts "Bad Boy" Reg D Disqualifications
  - Requires the SEC to issue rules by July 21, 2011 disqualifying any securities offering under Rule 506 of Reg D by felons and other "bad actors," including violators of certain state or federal securities laws
- Requires Private Funds Advised by Registered Adviser to Maintain Records and Confidentially Report to the SEC and Financial Stability Oversight Council Certain Information on Form PF

FORM PF

Form PF – Systemic Risk Reporting

- Newly proposed Advisers Act Rule 204(b)-1 would require SEC registered private fund advisers (*i.e.*, funds relying on Section 3(c)(1) or 3(c)(7) of the ICA) to file Form PF with SEC ("Private Fund Advisers")
- The information collected on Form PF will be shared with the newly created Financial Stability Oversight Council ("FSOC")
- Information reported on the Form would not be public (*i.e.*, generally not subject to FOIA request)
- Form PF is designed to assist the FSOC in its assessment of systemic risk in the U.S. financial system
- First filings due in early 2012

Form PF – Periodic Reporting

- Annual Reporting: A Private Fund Adviser would be required to report certain basic information about its private funds at least once a year on Form PF within 90 days of the Private Fund Adviser's fiscal year end
- Quarterly Reporting: Large Private Fund Advisers (*i.e.*, Private Fund Advisers with over $1 billion of hedge fund, private equity or liquidity fund AUM) must provide more detailed information and file Form PF within 15 days of each calendar quarter

Form PF – Definition of Hedge Fund

- Form PF solicits different information from hedge funds, private equity funds and liquidity funds (*i.e.*, money market funds)
- Hedge Funds – are defined as any private fund that:
  - Has a performance fee or allocation calculated by taking into account unrealized gains; or
  - May borrow an amount in excess of one-half of its NAV (including committed capital) or may have gross notional exposure in excess of twice its NAV (including committed capital); or
  - May sell securities or assets short

Hedge Fund Reporting on Form PF

- Hedge Fund Managers would be required to report various information on Form PF, including:
  - Fund manager information, including:
    - name;
    - related persons; and
    - aggregate total and net AUM by type of fund advised
  - Each advised private fund's information, including:
    - name of each advised fund and related persons (generally would not need duplicative information for master-feeder funds)
    - gross and net assets;
    - aggregate notional value of derivative positions;
    - basic information about fund's borrowings, including a breakdown of borrowings based on whether the creditor is U.S. or non-U.S. financial institution or non-financial institution and amounts owed to creditors when loans are over 5% of fund's NAV;
    - derivative positions;
    - detailed fund performance information;
    - investor concentration levels;
    - investment strategies;
    - percentage of assets managed using computer-driven trading;
    - significant counterparty exposure (including identity of counterparty); and
    - trading and clearing practices

Form PF - Additional Reporting by Large Hedge Fund Advisers

- Large Hedge Fund Advisers (*i.e.*, advisers with more than $1 billion in hedge fund AUM) will be required to report additional aggregate information about managed hedge funds, including:
  - market value of assets invested in different types of securities and commodities;
  - duration of fixed income portfolio holdings (including indicating interest rate sensitivity);
  - turnover rate of manager's aggregate portfolios during a calendar quarter; and
  - geographic breakdown of investments held

Form PF - Reporting For Hedge Funds with Over $500 Million in Assets

- Large Hedge Fund Advisers must report even more detailed information for each hedge fund with over $500 million in assets, including:
  - the quality of the fund's portfolio liquidity;
  - concentration of positions;
  - collateral positions with significant counterparties;
  - the identity of and clearing relationship with its three largest clearing counterparties;
  - certain risk metrics (*e.g.*, VaR metric if calculated by the fund);
  - certain financing information;
  - certain investor information; and
  - certain fund liquidity information (*e.g.*, side pocket and gate provisions)

SEC “PAY TO PLAY” RULE

SEC "Pay to Play" Rule - Background

- "Pay to play" is the practice of making campaign contributions and related payments to elected officials in order to influence the awarding of contracts for the management of public pension plan assets and similar government investment accounts.
- In response to recent actions brought at both the state and federal level (particularly with respect to placement agents), the SEC proposed a new pay to play rule in August 2009 and ultimately adopted the rule in June 2010 with some changes as a result of comments received.
- The new rule will require registered and unregistered investment advisers and certain senior level employees to restrict state and local political contribution and solicitation activities if the adviser manages public plan assets.

Rule Prohibitions

- The new rule adopted under the Advisers Act anti-fraud provisions prohibits an investment adviser:
  - from providing advisory services for compensation to a government entity for two years after the adviser or its "covered associates" make a contribution (above a de minimis amount) to certain elected officials or candidates of the government entity;
    - Government entity investing in Section 3(c)(1)/3(c)(7) fund covered by prohibition.
  - to solicit others, or coordinate, (a) contributions to certain elected officials or candidates or (b) payments to state or local political parties, in each case, where the adviser is providing or seeking government advisory business;
    - "Solicit" means to communicate, directly or indirectly, for the purpose of obtaining or arranging a contribution or payment.
    - Direct contributions by "covered associates" to political party or PAC not expressly prohibited, but due diligence required that not earmarked for government officials.

Rule Prohibitions

  - from providing or agreeing to provide, directly or indirectly, payment to any third party (*i.e.*, placement agents or similar parties) for a solicitation of advisory business from any government entity on behalf of such adviser unless such person is a "regulated municipal advisor."
- Rule also contains broad anti-avoidance/anti-structuring language prohibiting an adviser or a covered associate from doing anything indirectly which, if done directly, would result in a violation of the rule.

Scope of Prohibitions

- Rule applies to advisers (*e.g.*, GPs/management companies) and their "covered associates."
- Applies to SEC registered advisers, exempt reporting advisers, foreign private advisers and, until July 21, 2011, unregistered advisers relying on the fewer-than-fifteen client exemption.
- Adviser "covered associates" generally consist of presidents, vice presidents in charge of a principal business function, employees that perform policy making functions and employees that solicit government entity business.
  - The definition of "<u>covered associate</u>" specifically provides that a covered associate is:
    - any general partner, managing member, or executive officer (defined below), or other person with a similar status or function;
    - any employee who solicits a government entity for the adviser and any person who supervises, directly or indirectly, such employee; and
    - any political action committee (PAC) controlled by the adviser or persons described in the previous two bullet points.
  - "<u>Executive officer</u>" is defined as:
    - the president;
    - any vice president in charge of a principal business unit, division, or function (such as sales, administration, or finance);
    - any other officer who performs a policy making function; and
    - any other person who performs similar policy making functions for the adviser.

Contributions and Government Entities Covered

- The rule covers "contributions" to designated "officials" of "government entities."
  - "Contributions" means any gift, subscription, loan, advance, or deposit of money or anything of value made for (1) the purpose of influencing any election for federal, state, or local office; (2) payment of debt incurred in connection with any such election; or (3) transition or inaugural expenses of the successful candidate for a state or local office.
    - Excludes donation of time if adviser's resources (*e.g.*, office, telephones, etc.) not used.
    - Excludes charitable donations to 501(c)(3) entities at request of government official.
  - "Government entities" means any state or political subdivision of a state, including (1) agencies, authorities, or instrumentalities of the state or political subdivision; (2) a pool of assets sponsored or established by the state or political subdivision or any agency, authority, or instrumentality thereof; (3) a plan or program of a government entity; and (4) officers, agents, or employees of the state or political subdivision or any agency, authority, or instrumentality thereof, acting in their official capacity.
  - "Official" means any person (including any election committee for the person) who was, at the time of the contribution, an incumbent, candidate, or election winner if the office (1) is directly or indirectly responsible for, or can influence the outcome of, the hiring of an investment adviser by a government entity; or (2) has the authority to appoint any person described in (1) above.

Exceptions and Exemptions

- De minimis exception available to covered associates (but <u>not</u> the adviser) for:
  - contributions to an official of $350 or less per election if the adviser's covered associate is entitled to vote for the elected official; and
  - contributions to an official of $150 or less per election if the adviser's covered associate is <u>not</u> entitled to vote for the elected official.
- Limited relief exists in cases of small inadvertent (and then refunded) prohibited contributions.
- The SEC may also exempt contributions under a multi-factor exemptive relief analysis.

Prohibition is Compensation Not Contributions

- SEC release makes clear that restriction is not on political contributions or provision of advisory services, but instead on the adviser's receipt of compensation from the government entity.
- SEC release notes does <u>not</u> restrict "making independent expenditures to express support for candidates, volunteering, making speeches and other conduct."
  - Note, however, such activity needs to be carefully structured to avoid violating the rule against soliciting contributions or payments to political parties.

Two-Year Compensation Ban

- Prohibition continues to apply to the adviser for two years after a prohibited contribution is made even if:
  - the covered associate ceased to be employed with the adviser
  - contribution "discovered" at a later date
- The rule's prohibitions will attach to the adviser even if the covered associate made the contribution before becoming employed by the adviser, provided that the look-back period is only 6 months (as opposed to two years) for new employees not involved in soliciting government entities.
  - Two year look-back applies for employees soliciting government entities (and their supervisors).
- No look-back for contributions made prior to effective date of March 14, 2011.

Recordkeeping

- Registered advisers are also subject to recordkeeping obligations to demonstrate to SEC examination staff the adviser's compliance with the rule's requirements, including:
  - Names, titles and addresses of all covered associates.
  - Government entities invested in a fund advised by the adviser within the last 5 years.
  - Direct or indirect contributions made by the adviser or its covered associates to an official of a government entity, or direct or indirect payments to a political party of a state or political subdivision thereof, or to a political action committee.
  - Name and address of each placement agent (or similar entity) to whom the adviser provides or agrees to provide, directly or indirectly, payment to solicit a government entity for advisory services.

Effective Dates

- Advisers must be in compliance with the contribution and solicitation restrictions and recordkeeping obligations (for RIAs) by March 14, 2011.
- Advisers must be in compliance with the registered municipal advisor rule by September 13, 2011.
  - Expect FINRA final rule by then.

State Laws and Public Plan Policies

- States and/or public plans may adopt laws and policies more stringent than the SEC's pay to play rule and should be examined in connection with any contribution.

Compliance Implementation

- Political contribution policy with pre-clearance and reporting regime.
- Pre-employment screening.
- Employment/partnership provisions – consider compensation offsets/givebacks if covered associate triggers 2 year compensation ban.

STATE LOBBYIST RESTRICTIONS

California Lobbying Law – General Rule

- The law prohibits a person from acting as a "placement agent" in connection with any potential investment made by a California state public retirement system – CalSTRS, CalPERS and the University of California pension system – unless that person is registered as a lobbyist and is in compliance with California laws regulating lobbyists.
  - "Placement agent" means "any person hired, engaged, or retained by…an [investment] manager…who acts or has acted for compensation as a finder, solicitor, marketer, consultant, broker, or other intermediary in connection with the offer or sale of the securities, assets, or services of an [investment] manager to" a California state public retirement system.

California Lobbying Law – General Rule

- The definition of placement agent excludes "an individual who is an employee, officer, director, equityholder, partner, member, or trustee of an [investment] manager and who spends one-third or more of his or her time, during a calendar year, managing the securities or assets owned, controlled, invested, or held by the [investment] manager."
  - Fund sponsors will either need to limit California state public retirement system marketing activities to those that meet the one-third test or have certain of their personnel register as lobbyists.
  - To date, there is limited additional guidance on the one-third test. CalPERS, a co-sponsor of the law, has taken the position that private fund professionals, such as a typical CFO, that have a "limited and intermittent role" in fundraising are not placement agents within the meaning of the definition.

Prohibition on Contingency Fees

- Lobbyists may not accept or agree to accept any payment in any way contingent upon the outcome of any proposed administrative action, which would include a decision by any state agency to enter into a contract to invest state public retirement system assets on behalf of a California state public retirement system.
  - The law allows a placement agent registered with the SEC and regulated by FINRA to receive fees for "contractual services" provided to an investment manager so long as such fees are not contingency fees.

Lobbyist Law Requirements

- In order for an investment adviser to register an employee as a lobbyist, two forms must be filed. One form to register the investment adviser as a "lobbyist employer" and the other form to register the employee as a "lobbyist." The forms need to be filed prior to contact with the applicable California state public retirement system.
- In order for an investment adviser to engage a placement agent to solicit a California state public retirement system, it will need to complete a form authorizing the placement agent to act on its behalf. As a result, the investment adviser will be a lobbyist employer and subject to the lobbying law requirements. The forms need to be filed prior to contact with the applicable California state public retirement system.

Lobbyist Law Requirements

- Once registered as a lobbyist employer and a lobbyist, both the investment adviser and the employee are subject to California lobbying law requirements. These requirements include:
  - Filing quarterly reports regarding lobbying expenses, gifts and political contributions.
  - A requirement that the lobbyist employee attend an in-person ethics course within 12 months of registering as a lobbyist.
  - No political contributions and no gift of more than $10/month may be made to officials of the applicable California state public retirement system.
  - Having a recordkeeping system in place to ensure accuracy and reliability of records.
  - Being subject to an audit by the Franchise Tax Board.

California Local Plans

- The law also requires a person acting as a placement agent in connection with any potential investment made by a California local public retirement system (*e.g.*, Los Angeles City Employees' Retirement System (LACERS)) to file any applicable reports with a local government agency that requires lobbyists to register and file reports and to otherwise comply with any applicable requirements imposed by such local government agency.

Penalties for Non-Compliance

- If knowingly or willfully violate the lobbying laws, can be guilty of a misdemeanor.
- Subject to fines.
- May be barred from acting as a lobbyist in California for up to 4 years.

Effective Date and Further Guidance

- The effective date of the law was January 1, 2011.
- The Fair Political Practices Commission (the "FPPC") is considering adopting clarifying regulations.
- The FPPC is expected to post additional information about the quarterly reporting requirements.

New York Lobbying Law – Background

- New York City's Lobbying Law (NYC Admin. Code Title 3 §§ 3-211-233).
- The statute is not new, although its application to investments by NYC pension plans in private funds is new.
  - Began being applied as a result of an advisory opinion issued by the New York corporation counsel to the New York City Clerk on March 31, 2010, which concluded that placement agents and fund adviser personnel involved in solicitation of NYC plan business qualified as "lobbyists" under the Lobbying Law.
  - The advisory opinion was not publicized by the City Clerk until December 29, 2010, when the City Clerk sent a form letter to a number of private fund managers announcing that the Lobbying Law applies to the activities of placement agents and fund adviser personnel involved in soliciting investments from NYC plans.

New York Lobbying Law – Background

- NYC pension plans:
  - New York City Employee Retirement System
  - New York City Police Pension Fund
  - New York City Fire Department Pension Fund
  - New York City Teachers' Retirement System
  - New York City Board of Education Retirement System

General Rule

- Requires placement agents (whether or not SEC-registered), other third parties and investment advisory firms (and their employees) who attempt to influence the investment decisions made by New York City pension plans, to register as lobbyists if their compensation attributable to solicitation of such plans exceeds $2,000 per year ("Lobbyists").
  - Unlike the California rule, there is no exception for investment management professionals, or for any other fund sponsor personnel.
- Also requires filings by "clients" of lobbyists (*i.e.*, those who retain or employ a person meeting the definition of lobbyist) ("Clients").

General Rule

- Once registered, Lobbyists and their Clients must also comply with other restrictions and reporting requirements, including a prohibition on receiving compensation that is contingent upon successful solicitation of an NYC plan.
- Failure to comply constitutes a Class A Misdemeanor, punishable by civil fines of up to $30,000 per violation.
  - Note that misdemeanors may be disclosable on an RIA's Form ADV.
  - It is also conceivable that a misdemeanor could trigger the new Reg D "bad boy" disqualification under Dodd-Frank, depending on how the provision is worded.

Registration Requirements

- Fund sponsors that reasonably expect to pay more than $2,000 in annual compensation cumulatively to their own personnel for soliciting business from NYC plans must file registration statements and periodic reports, listing themselves as both a Client and a Lobbyist. Fund sponsor personnel that reasonably expect to receive more than $2,000 in annual compensation relating to soliciting business from NYC plans* must file registration statements and periodic reports, listing themselves as Lobbyists.

*Although it is somewhat unclear, this may be calculated based on total compensation paid to the employee multiplied by the percentage of time spent in soliciting NYC plan business.

Registration Requirements

- Placement agents that reasonably expect to earn over $2,000 in annual compensation cumulatively from soliciting business from NYC plans must file a registration statement and periodic reports for each fund sponsor that retains them, listing themselves as a Lobbyist.
- Fund sponsors that reasonably expect to pay more than $2,000 in annual compensation to placement agents to solicit NYC plans must file periodic Client reports.

Contingent Compensation Prohibited

- Clients are not permitted to retain, employ, or designate any lobbyist if the rate or amount of compensation is partly or wholly contingent on the successful solicitation of NYC plan business.
- Lobbyists are similarly prohibited from receiving any such contingent compensation.
- Fees paid to placement agents would thus seem to be prohibited if the fees are contingent on an NYC plan's investment in a fund (which would include most traditional placement agent compensation structures).

Contingent Compensation Prohibited

- Currently, it is unclear whether a bonus payment to a fund sponsor's Lobbyist employee who engages in lobbying activities as part of his or her employment would be considered as a form of prohibited contingent compensation under the Lobbying Law. (Note that such payments might raise separate issues under an Exchange Act/broker-dealer analysis.)

Filing Requirements for Lobbyists

- Registration Requirements
  - A separate Statement of Registration must be filed by a Lobbyist each calendar year for each Client. Filed via NYC's e-Lobbyist website. Due on Jan. 1, or within 15 days of being retained. Amendments must be filed within 10 days if any change in information contained in a Statement of Registration occurs. Filing Fees: $150 for the first Client, and $50 for each additional Client.
  - The Statement of Registration will include certain information about the Lobbyist, its lobbying activities and its employees who engage in lobbying activities.
  - The Lobbyist must also file the written retainer agreement between the Lobbyist and the Client (or, if there is no such written agreement, a written statement summarizing the terms of the oral agreement).

Filing Requirements for Lobbyists

- <u>Reporting Requirements</u>
  - Six bi-monthly periodic reports must be filed each calendar year.
  - Any Lobbyist who engages in fundraising or political consulting activities in any calendar year in which the Lobbyist is registered, or in the six months preceding any such calendar year, must also file fundraising and political consulting reports.

Filing Requirements for Clients

- Must file a Client Annual Report. Filed via NYC's e-Lobbyist website. Due on Jan. 15 of each year, unless the Client lobbies on its own behalf and registers as a Lobbyist.

Filing Requirements for Lobbyist-Clients

- Where a person, such as a fund sponsor, is both a Lobbyist and a Client, the Lobbyist-Client must comply with the Lobbyist filing requirements.
- In its Statement of Registration and other required filings, the Lobbyist-Client would include itself as both a Lobbyist and a Client.
- The Lobbyist-Client would not be required to file a Client Annual Report with respect to its own lobbying activities. However, it would be required to file a Client Annual Report concerning lobbying activities conducted on its behalf by another third-party Lobbyist (*e.g.*, a placement agent).

Other Requirements and Considerations

- Notice of Termination of Lobbyist. A Client and its Lobbyist must submit written notice of termination within 30 days after a lobbying agreement is terminated. The Lobbyist must still submit a bi-monthly periodic report for the period(s) in which lobbying occurred prior to termination, and both Lobbyist and Client must file a Lobbyist Annual Report and Client Annual Report, respectively, for the calendar year in which the termination took place.
- Campaign Contribution Limits. Lobbyists may not make campaign contributions exceeding the following limits per calendar year: Mayor/Public Advocate/Comptroller: $400. Borough President: $320. City Council: $250.

Other Requirements and Considerations

- Fundraising and Political Consulting Reports. Lobbyists who solicit contributions for a candidate running for a City office or who, for compensation, participate in the campaign of a candidate running for a City office or who provide political advice to the mayor or certain other City offices are required to file fundraising and political consulting reports.
- Prohibition on Gifts to Public Servants. Lobbyists are generally prohibited from giving gifts to NYC public servants. The prohibition also extends to gifts given by a Lobbyist's employees, or by a Lobbyist's or employee's spouse, domestic partner or unemancipated children. "Gift" is defined under applicable rules as anything of $50 dollars in value or more, although note that the NYC Comptroller has declared a prohibition on all gifts of any value whatsoever, in any form.

Other Requirements and Considerations

- <u>NYC Comptroller Requirements</u>.
  - Effective July 1, 2010, the NYC Comptroller adopted a set of additional requirements that all sponsors of funds in which NYC plans are invested were required to adopt. In communications recently sent to a large number of fund sponsors, the Comptroller has stated that penalties for failure to comply include "<u>termination of the Systems' investment commitment to a fund and any obligation to pay management or incentive fees, including carry, going forward</u>."
  - *Use of Placement Agents*. Private equity fund sponsors are prohibited from using placement agents to secure investments from NYC plans. Hedge fund and other fund sponsors are required to disclose all fees and compensation paid to any placement agent in connection with securing investments from NYC plans. All placement fees must be borne by the fund sponsor. All fund sponsors must disclose any placement fees paid in connection with securing commitments from any other (*i.e.*, non-NYC plan) investors in the fund.

Other Requirements and Considerations

- NYC Comptroller Requirements (cont'd)
  - *Monitoring City Contacts*. All fund sponsors must disclose all contacts with employees of the City Comptroller's Office regarding new investments, as well as contacts with other individuals (such as the boards of trustees of the NYC plans), involved in the investment decision-making process with respect to the NYC plans.
  - *Gifts*. No fund sponsor or its personnel may give any gifts of any value whatsoever, in any form, to any NYC civil servants.

Other Requirements and Considerations

- Recordkeeping Requirements. Lobbying records must be kept for five years by Lobbyists and Clients, including:
  - Compensation of any kind or amount with respect to lobbying activities;
  - Names and addresses of every person paying or promising to pay compensation of $50 or more and the date of that promise;
  - Names and addresses of every person to whom any item of expenditure of more than $50 is made and a receipted bill for each expenditure; and
  - All expenditures made by or on behalf of the Client.
- Additional Ethics Requirements.
- All Lobbyist and Client filings are public.

Further Guidance

- A number of parties are seeking further guidance from the New York City Clerk's office.
- An advisory opinion is expected from the City Clerk's office in the near future.
- Early indications are that the City Clerk seems actively opposed to providing relief for fund sponsors in this area.

FOREIGN CORRUPT PRACTICES ACT

Foreign Corrupt Practices Act - Background

- The SEC recently launched an investigation into possible violations of the Foreign Corrupt Practices Act by financial institutions, including banks, hedge funds, and private equity firms that have sought investments from or partnerships with sovereign wealth funds. The DOJ has also historically been active in this area and, although it has not publicly joined the SEC in this investigation, it often coordinates efforts with the SEC in areas of mutual concern.
- The FCPA prohibits, among other things, payments, directly or indirectly:
  - By or on behalf of issuers whose securities are registered on U.S. exchanges, U.S. nationals and other U.S. persons, U.S. entities, non-U.S. entities having a principal place of business in the U.S., or any individual or entity using the instrumentalities of U.S. interstate commerce.
  - To "any foreign official for the purpose of inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality."
- Can result in large fines and penalties, which may be dwarfed by the enforcement- and litigation-related costs, as well as reputational damage.

FCPA Applied to Investments by Sovereign Wealth Funds

- U.S. officials likely view employees of sovereign wealth funds as meeting the FCPA's definition of "foreign officials."
  - Both the SEC and the DOJ have long held broad interpretations as to what constitutes a government "instrumentality". Can be even triggered where a non-U.S. government owns a minority stake in the enterprise.
  - This broad interpretation has not yet been tested in court.
  - However, litigation can raise significant "headline risk" for a defendant, creating pressure to settle quickly.
- "Payment" under the FCPA is also interpreted broadly to include essentially anything of value, including in-kind benefits, such as travel or entertainment in certain cases.*
  - Indirect payments through intermediaries would also be covered.

*Note that the FCPA does permit payment or reimbursement of reasonable and bona fide expenses of a foreign official (*e.g.*, travel and lodging expenses) relating to the promotion, demonstration or explanation of a product or service. However, what would be considered "reasonable" (*e.g.*, a lavish dinner, or a suite at the Four Seasons) is subjective, and is likely to be viewed narrowly by the SEC and DOJ.

FCPA Compliance

- Any private fund sponsor seeking an investment from a sovereign wealth fund should be sensitized to the FCPA's requirements and the attendant enforcement risk.
- An FCPA compliance policy should be considered, with the policy's level of detail being dependent on how extensive the fund's dealings are with sovereign wealth funds.

AIFM DIRECTIVE

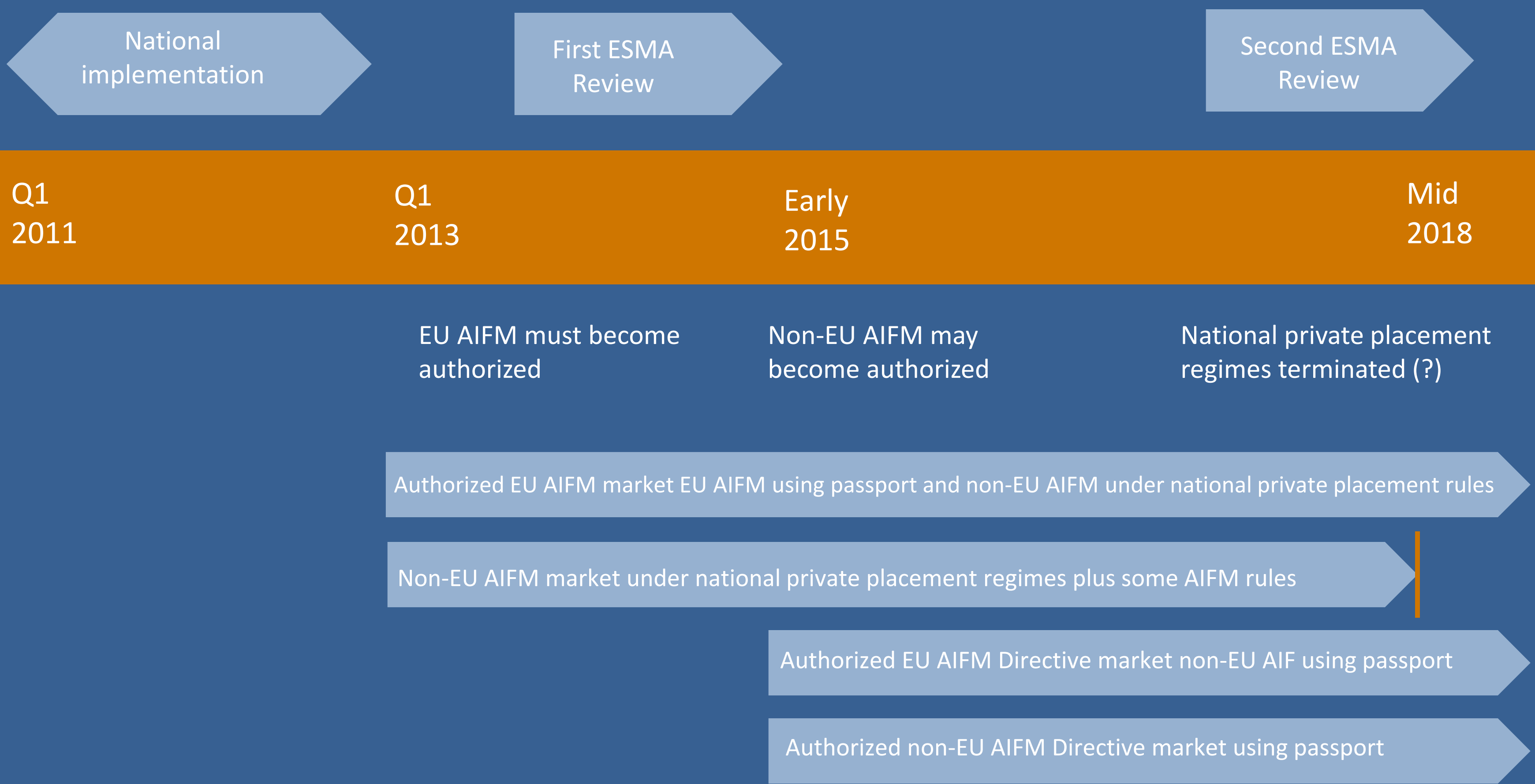
AIFM Directive

- New EU legislation introducing a pan-European regulatory regime for managers of alternative investment funds, including hedge funds, private equity funds, funds of funds, etc.
  - Any fund that is not a “UCITS” is an “alternative investment fund”
- Applies to any fund manager who:
  - Markets funds within the EU
  - Has its registered office in the EU
  - Manages an EU fund
- Applies regardless of where fund is based, so includes:
  - Non-EU-based fund managers who raise money from EU investors
    - *e.g.*, U.S.-based fund manager (including hedge fund managers)
  - EU-based managers of non-EU funds
    - *e.g.*, London-based manager of Cayman or Channel Islands funds

AIFM Directive - Authorization

- Fund managers within scope must be authorized by (*i.e.*, registered with) an EU regulator
  - Authorized managers have "passporting" rights
    - Can provide fund management services and market fund interests to institutional investors across the EU under a single set of rules
  - Implementation will be staged
    - Non-EU fund managers will not be eligible for authorization until 2015
    - EU-based firms must apply for authorization from 2013
  - Authorized firms are subject to extensive compliance obligations, including:
    - Regulatory capital requirement
    - Conduct of business rules
    - Limits on leverage
    - Custody rules
    - Valuation rules
    - Reporting requirements – to fund investors and to regulator
    - Remuneration code

AIFM Directive - Implementation Timetable



THE VOLCKER RULE

The Volcker Rule - Application

- Covered Entities – All bank holding companies (“BHCs”) and their subsidiaries and affiliates (*i.e.*, every entity in an organizational structure that has a bank).
  - Large, systemically important non-bank financial companies (*e.g.*, large broker-dealers) that are supervised by the Fed will be subject to additional capital and quantitative restrictions for Covered Fund investments.
- Covered Funds – All §3(c)(1) and §3(c)(7) funds and “similar funds.”
  - Explicit exception for SBIC investments.
  - Does not apply to completely offshore activity (*e.g.*, an offshore bank not controlled by a U.S. parent investing in an offshore fund with no U.S. investors).

The Volcker Rule – Prohibitions and Exceptions

- *No Direct Investments in Third Party-Sponsored Funds* – All direct investments by a Covered Entity in a private fund sponsored or managed by a third party are prohibited (except for SBICs).
  - Subject to rulemaking, Covered Entities may be able to indirectly invest in third party-sponsored funds through fund-of-funds vehicle under "organizing and offering" exemption (discussed below).
- *Limited "Organizing and Offering" Exemption for Sponsored Funds* — Covered Entity may sponsor a Covered Fund ("Sponsored Fund") and provide 100% of seed capital only if:
  - Equity or partnership interest is reduced to not more than 3% of the "total ownership interests" of any Sponsored Fund within one year.
  - Aggregate of all Sponsored Fund investments do not exceed more than 3% of Tier One Capital.
  - Covered Entity provides bona fide trust, fiduciary or investment advisory services to the Sponsored Fund and the sponsored Fund is organized and offered in connection with such services.
  - Covered Entities do not guarantee or insure the obligations or performance of the Sponsored Fund and makes it clear to investors that losses will be borne solely by investors, not any Covered Entity.
  - No director or employee of the Covered Entity takes or retains any equity or partnership interest unless directly engaged in provision of advisory or other services.
  - The Sponsored Fund and Covered Entities do not share the same name or variation of the same name.

The Volcker Rule - Timing

Transition Period (4 Years)

- *Two Years Until the Effective Date* — Volcker Rule is effective at the earlier of two years (July 21, 2012) or 12 months from the adoption of final rules by federal regulators. No technical limitation on new investments by Covered Entities until that time.
- *Two-Year Transition Period after the Effective Date* — Covered Entities will have two years from the Effective Date to come into compliance.

Extensions (3-8 Years after Transition Period)

- *Three One-Year Extensions* — The Fed may by rule or order extend the transition period for not more than a year at a time, but not to exceed three years.
- *Up to Five-Year Illiquid Fund Extension* — The Fed may grant by application up to a five-year extension for "illiquid funds," defined as a Covered Fund which as of May 1, 2010, principally invests in illiquid investments. "Illiquid fund" definition is designed to apply to private equity and real estate funds, not hedge funds.

DERIVATIVES UPDATE

Derivatives Update - Overview

- The Dodd-Frank Act initiated sweeping reforms to the regulation of derivatives
- SEC, CFTC still in process of implementing changes initiated by Dodd-Frank
  - Significant rulemaking since November 2010 , industry sea change expected in coming months
  - Nearly all rules currently in non-final proposed format
  - Industry groups pleading for more time to comment on revisions

Derivatives Update - Overview

- Proposed rules would require:
  - all swaps to fall under SEC or CFTC jurisdiction
  - central clearing of nearly all over-the-counter derivatives transactions
    - will likely impede cross-margining of positions across trading lines
    - related increase in collateral, margin and transaction costs
  - recordkeeping, subject to regulator inspection, of all derivatives trading by all market participants
  - commodity pool operator / commodity trading advisor registration for nearly all investment managers who employ futures or derivatives as part of investment strategy
  - registration (with SEC and/or NFA) and significant additional compliance requirements on entities with swap dealer function or significant amounts of derivatives exposure

Swaps Under Regulator Authority

- OTC Derivatives brought under the authority of CFTC and SEC
  - Securities-based swaps will be "securities" under Securities Act, Exchange Act definition, regulated by SEC
    - includes single-stock or single-loan TRS, narrow-based index or basket TRS, single-name or narrow-based CDS, certain loan-based swaps
  - All other swaps subject to CFTC regulation
    - includes interest rates, energies, broad-based CDS, broad security baskets and indices, agricultural swaps
    - currently includes foreign currency swaps, but Treasury considering exemption under October Notice and Request for Comment

Swaps Under Regulator Authority

- Central clearing required of nearly all swaps
  - to include standardized and commonly traded swaps accepted by a clearinghouse
  - exceptions where one party is not a financial entity or is using swap to hedge commercial risk
  - additional SEC / CFTC clarification to come
- CFTC imposing position limits across futures and swaps markets
  - SEC to provide limits for security-based swaps in future rulemaking
- All swaps subject to CFTC antifraud, registration, reporting and recordkeeping authority

New Regulation of Derivatives Users

- CFTC eliminating longstanding exemptions from commodity pool operator / commodity trading advisor regulation
  - Proposes eliminating exemptions under Regulations 4.13(a)(3) (exemption for minimal trading of commodity futures contracts) and 4.13(a)(4) (exemption for commodity pools with sophisticated investors)
  - Proposes modifications to "eligible contract participant"
    - adds look-through requirement, such that each investor in a commodity pool (*e.g.*, private fund) wishing to qualify as an ECP must itself be an ECP
    - proposes to exclude commodity pools from qualification under other prongs of ECP definition
- As a result, under current proposals, nearly every private fund manager wishing to trade in commodity futures and/or non-security-based derivatives must register with NFA as a commodity pool operator and/or commodity trading adviser.
  - Regulation 4.7, which requires registration but lessens compliance burdens on CPOs to QP funds, still expected to be available

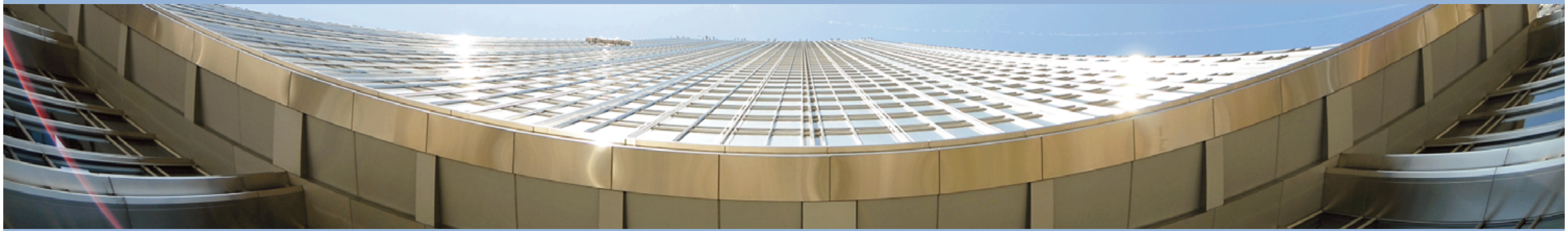
New Regulation of Derivatives Users

- Swap Dealer
  - Conduct test, *e.g.*, holds out to potential swaps counterparties, makes market in swaps
- Major Swap Participant
  - Generally an entity that fits any of the following:
    - maintains substantial positions in swaps, generally ≥$1BB in average daily uncollateralized exposure / ≥$2BB combined current and future exposure for each category of swap
      - higher $3BB / $6BB thresholds for rate swaps
      - future exposure to be determined by formula set out by SEC / CFTC
      - hedged amounts excluded
    - has substantial counterparty exposure that could have systemic effect
      - ≥$5BB average daily / ≥$8BB current and future swap exposure across all swap categories
    - is a financial entity that is highly leveraged and maintains substantial positions in swaps

New Regulation of Derivatives Users

- Swap dealers and MSPs to be subject to substantial requirements:
  - registration with applicable regulator, related compliance:
    - minimum capital and margin requirements
    - reporting and recordkeeping
    - policies covering compliance, risk management, business continuity, supervision
    - business conduct standards
    - implementation of systems to avoid conflicts of interest
    - appointment of chief compliance officer
  - if entering into non-cleared derivatives transaction with unregistered counterparties (*e.g.*, derivatives end-users), must provide option of segregating initial margin with third-party custodian
- All swaps users required to maintain records of swaps use, subject to inspection by applicable regulator

QUESTIONS?



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Reporting and Tax Update for Hedge Funds

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Agenda

- FASB Accounting and Reporting Developments
- Hot Topics in Investment Valuation
- Developments in Accounting for Uncertain Tax Positions
- Introduction of IRS Form UTP
- Update on FATCA and FBAR
- Tax Legislation Enacted in 2010
- Obama Administration's Fiscal 2012 Tax Proposals

FASB ACCOUNTING AND REPORTING DEVELOPMENTS

Fair Value Measurements and Disclosures (Topic 820)

- ASU 2010-06 (Topic 820) – Improving Disclosures about Fair Value Measurements
  - Effective for interim and annual periods beginning after 15 December 2009
    - Significant transfers in and out of Levels 1 and 2 (on a gross basis) and the reasons for those transfers
    - All transfers in and out of Level 3 and the reasons for those transfers; if significant, disclose on a gross basis
    - Fair value disclosures to be provided for each "class" of assets and liabilities -- a class of assets and liabilities will require:
      - Greater disaggregation than line items in the statement of financial position
      - Use of judgment
        - » Consider level of disaggregated information required by other topics in the Codification
    - Inputs and valuation techniques (including reasons for changes, if any) used to measure fair value for Level 2 securities, not only Level 3

Fair Value Measurements and Disclosures (Topic 820)

- ASU 2010-06 (Topic 820) – Improving Disclosures about Fair Value Measurements
  - Effective for interim and annual periods beginning after
    15 December 2010
    - Separate disclosure of purchases, sales, issuances and settlements in the Level 3 rollforward

Fair Value Measurements and Disclosures (Topic 820)

Description	12/31/2010	Level 1	Level 2	Level 3
Investments				
Equity securities - real estate industry	$ 93	$ 70	$ 23	$ -
Equity securities - oil and gas industry	45	45	-	-
Equity securities - other	15	15	-	-
Residential mortgage backed securities	149	-	24	125
Commercial mortgage backed securities	50	-	-	50
Collateralized debt obligations	35	-	-	35
U.S. Treasury securities	85	85	-	-
Corporate bonds	93	9	84	-
Total investments	$ 565	$ 224	$ 131	$ 210
Hedge fund investments				
Equity long/short	$ 55	$ -	$ 25	$ 30
Global opportunities	35	-	-	35
Distressed debt	90	-	-	90
Total hedge fund investments	$ 180	$ -	$ 25	$ 155
Derivatives				
Interest rate contracts	$ 57	$ -	$ 57	$ -
Foreign exchange contracts	43	-	43	-
Credit contracts	38	-	-	38
Commodity futures contracts	78	78	-	-
Commodity forward contracts	20	-	20	-
Total derivatives	$ 236	$ 78	$ 120	$ 38
Total	$ 981	$ 302	$ 276	$ 403

Fair Value Measurements and Disclosures (Topic 820)

- Exposure draft issued June 2010 - Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs
  - Comment deadline 7 September 2010
  - Final ASU expected Q1 2011
    - Effective date not yet determined
- Not intended to change application of requirements in Topic 820
  - Clarification about application of existing guidance
  - New disclosures about fair value measurements

Fair Value Measurements and Disclosures (Topic 820)

- Significant amendments include the following:
  - Clarifies highest and best use and valuation premise – not applicable for financial instruments
  - Clarifies fair value measurement for instruments classified as part of shareholders' equity
  - Allows for measurement of the fair value of financial instruments on a portfolio basis when a reporting entity manages its net exposure to market and credit risks that way
  - Prohibits application of blockage factors to fair value measurements at any level of fair value hierarchy
  - Specifies that Level 2 or 3 fair value measurements may take into account other premiums or discounts when market participants would consider these when pricing an asset or liability for the specified unit of account

Fair Value Measurements and Disclosures (Topic 820)

- Additional disclosures about fair value measurements:
  - Measurement uncertainty inherent in fair value measurements for Level 3 assets and liabilities
    - Disclose effect on fair value measurement of changing one or more unobservable inputs

Fair Value Measurements and Disclosures (Topic 820)

- Potential implications for asset management industry:
  - May change measurement of certain assets or liabilities classified as Level 2 or Level 3 due to either:
    - Elimination of blockage factor
    - Use of other premiums or discounts (*i.e.*, control premium, non-controlling discount)
  - Measurement of financial instruments on a portfolio basis
    - Offsetting market or credit risks can be combined for measurement purposes
  - Enhanced disclosure requirements
    - Measurement uncertainty analysis
      - May be difficult when measurement is based on broker quotes or when entity has little transparency into inputs used

Financial Instruments (Topic 825)

- Exposure draft released May 2010
- Expands use of fair value as a measurement attribute
- All financial instruments, except for those specifically exempted, measured at fair value
  - Changes to be reflected in the net increase (decrease) in net assets in the statement of operations
  - Includes financial liabilities
- Requires transaction costs be expensed immediately when incurred

Financial Instruments (Topic 825)

- Impact on investment companies
  - Transaction costs would be expensed and included in net income
    - Increase in expenses and expense ratios
  - Funds that issue debt would be required to measure that debt at fair value
    - Report both the fair value and the amortized cost value of the debt on the balance sheet
    - Fair value would be used to calculate net assets
    - Difficulty in calculating fair value of own debt
    - Counter-intuitive – NAV improves as credit worsens

Financial Instruments (Topic 825)

- Comment period ended 30 September 2010
- Next steps
  - Board re-deliberations expected to continue
  - Final ASU expected Q2 2011
    - If adopted, earliest expected effective date 1 January 2013

Balance Sheet Offsetting (Topic 210)

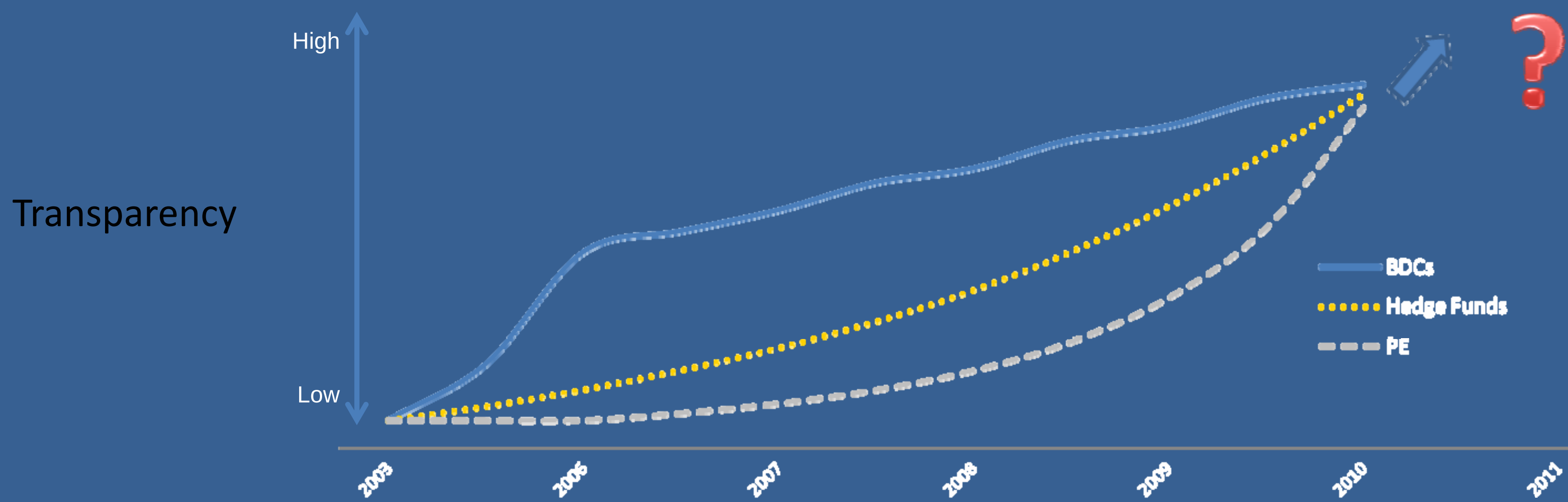
- Summary
  - Financial asset and financial liability would be required to be offset only if the entity has an unconditional and legally enforceable right of set-off and intends to settle the asset and liability on a net basis or simultaneously
  - Derivatives entered into with a counterparty under a master netting arrangement (*e.g.* conditional right of offset) would be required to be presented on a gross basis
- Investment types impacted:
  - Repurchase agreements (repos and reverse repos) and securities lending arrangements
  - Assets and liabilities arising from swap agreements, futures contracts and forward purchase and sale commitments
- Comments due by 28 April 2011 and final guidance expected by end of June 2011

HOT TOPICS IN INVESTMENT VALUATION

Transparency Around Valuations is Driven by Markets, Investors and Regulators

- Market changes
  - Market dislocation prompting illiquidity / inactive markets and distressed transactions
  - Privates become more visible
  - Alternative investment managers draw criticism in the press
- Investors mentality
  - Increased investor scrutiny following scandals
  - Investor shift focus on reporting / disclosure issues
- Regulatory environment
  - Introduction of fair value accounting
  - SEC, PCAOB and FASB push
  - Auditors increased scrutiny as a result

Catalysts Have Affected All Asset Manager Types at Different Points in Time



Catalyst			
Market	•Unprecedented liquidity and leverage •Financial innovations (securitization) •Institutionalization of alternatives	•Distressed / inactive markets •Redemptions / gates •Record bank failures	•Shedding of alternative divisions •Growth in secondary markets •Net Inflows in private investments •Newly publicly-traded PEs
Investor/ Public	•BDCs investor activism	•Madoff •Press frenzy •Diversity / challenges in financial reporting	•Focus on risk management transparency •Private investors more structured •Growth in alternative pricing options
Regulatory/ Auditor	•SEC action •FASB focus on fair value accounting	•ASC 820 / SFAS 157 effective •Numerous related FASB pronouncements (clarifying guidance) •SEC / PCAOB / AICPA letters •**Increased audit scrutiny**	•FASB-IASB Fair Value Measurements Disclosure project •SEC actions & Asset Management Unit •Dodd-Frank effective •AIFM Directive •Issuance of revised industry guidance

What to Expect?
SEC Comments and Trends on Valuations

- Development of specialized asset management unit
- Significant, highly visible actions scrutiny / actions taken
- Valuation areas of focus
  - Issues pertaining to the determination of, and disclosures related to, fair value measurements
    - Inquiries around the use of pricing information provided by third parties (*e.g.*, brokers, pricing services, appraisers)
    - Inquiries re nature a particular class of asset (*e.g.*, contractual rights)
    - Inadequate disclosure re valuation techniques and inputs used to estimate the fair value
    - Insufficient insight into managements processes / approach / rational

PCAOB's Focus on High Audit Risk of Valuations

- Deficiencies identified from latest release
  - Lack of clear understanding of the methods or assumptions used by external pricing sources
  - Inadequate test controls over management's valuation processes
  - Insufficient evaluation (and related documentation) of reasonableness significant assumptions associated with estimates
  - Inconsistency in approach across investments and with valuation policies

What We Have Seen?
Common Shortfalls in Valuation Reviewed

- Documentation
  - Weak support for assumptions used
  - Short memos with no sources
  - Inconsistent valuations between teams
- Application of methodology
  - Misapplied valuation approaches given nature of instrument
  - Unsubstantiated changes in methodology
  - No consideration of all meaningful contractual / economic rights
  - Misapplication of discounts / premiums
- Triangulation process
  - Un-reconciled differences in value between multiple approaches
  - No documentation about how the fair value conclusion was made

How We See Asset Managers Addressing This New Environment

- Valuation deficiencies exposed
  - reputational and legal risks
  - detrimental to marketing and fund raising efforts
- Revamping of valuation infrastructure
  - New valuation policy, procedures, and documentation with focus on consistency and completeness
  - Corporate governance / oversight
    - Independent valuation committees
    - Adequate controls, executive oversight (tone at the top)
  - Investments in resources: getting it done
    - Separation front-office and valuation functions
    - Hiring of new roles
    - Increasing use of third-party specialists

What to Know When Using a Third-Party Valuation Specialist

- Scope of offering
  - Review opinions
    - Negative assurance
    - Positive assurance
  - Valuation opinions
    - Limited scope
    - Full scope
  - Valuation advisory
- Trends towards opinions
- Be careful of low-price service providers
- Look for teams, credentials and unbias

What To Expect in the Near Future Around Valuation Reporting?

- Dodd – Frank will push for governance & compliance and SEC audits
- International convergence (AIFM, IAS) will drive new rules
- United investors (ILPA) may enact new transparency and governance rules
- Independent directors/committees may demand to interview valuation specialists directly
- Emergence of best practices will marginalize late comers

TAX UPDATE

Developments in Accounting for Uncertain Tax Positions

- Maintenance of established tax reserves
  - Penalties and interest
  - Statute of limitation
- Review of current portfolios holdings to evaluate uncertain positions
  - Changes in international tax rules related to self-assessed capital gain taxes
  - Administrative practice exception
  - Tax loss carry forward and tax calculations
  - Penalty and interest exposures
- Permanent Establishment Issues
  - Global operating guidelines
  - Trading safe harbor issues
- Planning
  - Use of derivatives
  - Use of treaty-based structures

Introduction of IRS Form UTP

- For 2010, corporations with $100 million or more of assets must file Schedule UTP if:
  - They file Form 1120, 1120-F, Form 1120-L or Form 1120-PC
  - Audited financial statements are issued
  - They have tax positions subject to disclosure on Schedule UTP
- Scope of UTPs to be reported:
  - Tax positions reflected on return for which an initial reserve has been recorded or
  - Tax position where no reserve recorded based on expectation to litigate
- Rank tax positions on annual basis by the amount of the reserve

Update on Foreign Account Tax Compliance Act (FATCA) and FBAR

- New U.S.-source dividend character for “dividend equivalent payments” on “specified notional principal contracts”
- Withhold on gross portion of swap payments corresponding to U.S.-source dividends on NPCs
- 14 September 2010 through18 March 2012 – a NPC is any NPC:
  - Underlying security is transferred between the two parties at either the commencement or termination of the contract (“crossing in” or “crossing out”)
  - Underlying security is not readily tradable on an established securities market
  - Underlying security is posted as collateral to the contract, or
  - Any other contract identified by the IRS as a specified notional principal contract
- For payments after 18 March 2012, every NPC is a NPC unless the IRS deems otherwise

FATCA – Notice 2010-60

- Focus of FATCA is on payments to foreign financial institutions (FFIs) and other foreign entities, and payments by FFIs
- FATCA rules categorize foreign entities as either FFIs or non-financial foreign entities (NFFEs)
  - Withholdable payments made to FFIs are subject to 30% withholding unless FFI has entered into an FFI Agreement with IRS under which it assumes information reporting and withholding responsibilities (or an exception applies)
  - Withholdable payments made to NFFEs are subject to 30% withholding unless NFFE identifies its substantial U.S. owners, or an exception applies
- U.S. financial institutions (USFIs) have FATCA obligations with respect to payments to FFIs and NFFEs

FATCA – Notice 2010-60

- Notice 2010-60 provides first round of Treasury and IRS guidance on FATCA, focusing on:
  - When payments are exempt from FATCA due to grandfathering rules
  - Whether an entity is an FFI and when such FFI must enter into an FFI Agreement
  - How a USFI or an FFI is to determine which of its existing and new accounts are held by U.S. persons
  - What information an FFI must report to the IRS on its U.S. accounts under an FFI Agreement

FBAR

- A US Person with a financial interest in or signature authority over foreign “financial accounts” that exceed $10,000 in aggregate at any time during the calendar year must file Form TD F 90.22-1 (the “FBAR”)
  - FBAR is not filed with the person’s tax return and must be received by Treasury in Detroit not later than June 30th of the following year
  - Significant penalties for failure to file
- Form instructions state that a financial account for this purpose includes bank, securities, securities derivative, and other financial instrument accounts. Also includes “any accounts in which assets are held in a commingled fund, and the account owner holds an equity interest in the fund (including mutual funds)”
- Significant confusion over FBAR filing requirements led IRS to delay filing dates for 2008 and prior years in some cases

- In fund context, FBAR filing generally required if:
  - US fund owns an interest in a foreign financial account
  - US fund owns 50% or more by vote or value of foreign company (directly or indirectly) and the foreign company has one or more foreign financial accounts
  - A US General Partner or other US person has signature authority over a foreign financial account
  - A US person owns an interest in a non-US fund that is treated as a financial account
    - After some initial confusion, IRS notices and proposed regulations clarify that foreign funds for this purpose are limited to foreign mutual funds and similar pooled funds, unless and until further guidance is provided
    - Thus, financial account does not include a foreign hedge fund, foreign PE fund or foreign VC fund

Section 6038D

- New Section 6038D enacted in 2010 requires an individual to report certain information on his or her federal income tax return to the extent the individual owns interests in "specified foreign financial assets" and the aggregate value of such assets exceeds $50,000 at any time during the year

- Specified foreign financial assets generally include:
  - any account maintained by foreign financial institution as defined under FATCA rules (and would generally include an interest in a foreign investment fund)
  - stock or securities issued by a non-US person
  - a financial instrument or contract where the counterparty is a non-US person
  - any interest in a foreign entity

- Reporting under Section 6038D is generally effective for tax years beginning after 3/18/10 and is in addition to any FBAR filing requirement

Tax Legislation Enacted in 2010

- On 17 December 2010, President Obama signed the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010."
- The law extends the Bush tax relief for all taxpayers through 2012, and extends tax provisions that expired in 2009, as well as certain other provisions that were set to expire at the end of 2010.
- It will affect both individual and business planning.

Tax Legislation Enacted in 2010 – Individual Implications

- Income tax rates of 10%, 25%, 28%, 33%, and 35% remain in effect through 2012
- 15% top rate on capital gains, dividends extended through 2012
- Personal exemption phase-out and itemized deduction limitation suspended through 2012
- AMT patched for 2010 and 2011
- Changes to the estate and gift tax
- 2-percentage-point employee payroll tax cut for 2011

Tax Legislation Enacted in 2010 – Business Implications

- Allows 100% bonus depreciation under Section 168(k) for capital purchases beginning 8 September 2010, through the end of 2011, and 50% bonus depreciation for investments in 2012
- Extends Section 179 expensing beginning in 2012 and sets maximum amount and phase-out threshold at $125,000 and $500,000, respectively, indexed for inflation
- Retroactively reinstates 15-year, straight-line cost recovery for qualified leasehold improvements, qualified restaurant buildings and improvements, and qualified retail improvements for property placed in service in 2010 and 2011

Tax Legislation Enacted in 2010 – Healthcare Reform Tax Increases

- 3.8% Unearned Income Medicare Contribution Tax
  - Applied to "net investment income" such as interest dividends, net gains attributable to the disposition of property
    - Also includes income from IRC Section 988 transactions and mark to market gains under IRC Section 475
  - Applies to passive activities
  - Effective 2013
- .9% increase on employee portion of hospital insurance tax
  - Self-employed individuals – increase from 2.9% to 3.8%
  - Deductibility
  - Effective 2013

Social Security and Medicare Taxes

- Wages paid to an employee in 2011 subject to:
  - social security taxes on amounts up to $106,800 annual wage base
    - 6.2% tax on employee (non-deductible)
    - 6.2% tax on employer (deductible)
  - medicare taxes (uncapped)
    - 1.45% tax on employee (non-deductible)
    - 1.45% tax on employer (deductible)
- Self-employed individuals (including partners) pay both employee and employer share of taxes on self-employment income
    - Self-employment income generally does not include allocations of income to an S corporation shareholder or a limited partner (other than a guaranteed payment to a partner for services)
    - Self-employment income generally does not include dividends, interest, capital gains earned by non-dealers

- Beginning 1/1/2013, 2010 legislation:
  - increases medicare taxes imposed on an employee's and self-employed individual's compensation/self-employment income in excess of $250k/$200K by 0.9% (non-deductible)
  - imposes a 3.8% medicare tax (non-deductible) on an individual's (i) passive investment income (e.g., dividends, interest, rents, capital gains) and (ii) income from a passive activity interest in a trade or business (e.g., an interest in a business conducted by a partnership or S corporation in which the individual does not materially participate), to the extent that the individual's AGI exceeds $250k/$200k

- Where an individual is both an employee and a shareholder of an S corporation, these rules create an incentive to minimize salary and bonus payments (which are subject to social security and uncapped medicare taxes) and instead pay out S corporation earnings as distributions to shareholders not subject to social security and medicare taxes
- Similar incentive for partners of a partnership to take their share of partnership income as an allocation of profit to a limited partnership interest and not as a guaranteed payment

Watson Case

- Watson was a CPA who practiced tax accounting as an employee of his wholly owned S corporation
  - Watson was paid a salary of $24k and during the relevant years received distributions of profit from the S corporation of $175k to $200k
  - No social security or medicare taxes were paid on the distributions
- The IRS argued Watson's salary was unreasonably low and that a portion of the S corporation distributions should be recharacterized as wages subject to social security and medicare taxes
- US District Court agreed and found that a reasonable salary for Watson was approximately $90k per year
- According to the WSJ, Watson plans to appeal

- Watson case shows importance of paying a reasonable salary to a person who is both an employee and shareholder of an S corporation

- How much is reasonable?

- Does the Watson case potentially apply to partners and partnerships, requiring a partnership to pay a reasonable guaranteed payment (subject to social security and uncapped medicare taxes) or face risk of recharacterizing partnership profit allocations and distributions as wages or guaranteed payments?
  - Under long-standing IRS rules, a partner who is a service provider cannot also be an employee of the same partnership. All returns to the partner/service provider are generally received in a partner capacity
  - Lack of dual status should make it difficult for IRS to apply Watson to require treating a portion of partnership allocations as wages or guaranteed payments
  - Payment of a reasonable guaranteed payment to a partner/service provider is, nonetheless, still a good idea

- The same 2010 tax bills that would have changed the tax treatment of carried interest would have repealed the exception to self-employment taxes for allocations of income to an S corporation shareholder or a limited partner where the S corporation or partnership was engaged in a professional service business (including investment management), but such bills were not enacted.
- Such bills, if enacted, would eliminate the planning opportunity Watson attempted to use
- Obama Administration 2012 budget does not appear to include a similar provision.

Obama Administration's Fiscal 2012 Revenue Proposals

- Return to pre "Bush Tax Cuts" ordinary income tax rates on ordinary income for joint taxpayers earning more than $250K per year.
- Maximum 20% tax rate on Long Term Capital Gains and Qualified Dividend Income (cost $124B)
- Carried Interest taxation (capital gain reclass, SE tax, and sale of ISPI) (raise $15B)
- Eliminate Section 1256 60/40 Treatment for Commodities and Options dealers (raise $3B)
- Limit Itemized Deduction benefit to maximum rate of $28% (raise $321B)
- Modify PAYGO Budget Baseline (Baseline assumes continuation of "middle class Bush tax cuts", estate tax rates and exemptions from 2009 tax year, and permanent AMT patch.)

Obama Administration's Fiscal 2012 Revenue Proposals

- Other Notable Proposals
  - Eliminate Tax Benefits to Oil & Coal Industry (IDC expensing, Percentage Depletion, & PAL exception)
  - Extend Active Financing Exception
  - Adopt Pooling Approach to Foreign Tax Credit Calculation
  - $30B Bank Tax
  - 163(j) Reform for Certain Foreign Corporations
  - Eliminate LIFO & LCM Accounting Methods for Inventory
  - Permanent Extension of R&D Tax Credit
  - Required IRAs for Certain Employees
- Total 10 Year Impact ($328B increased revenue; $443B tax increases less $115B tax decreases (as compared to baseline)).

Taxation of Carried Interest

- Current Law
  - <u>Rule #1</u> -- partnership income or loss from operations or asset sales flows through to a partner with the same tax character it has at the partnership level (e.g., capital gain or loss, interest income, dividend income, or ordinary income or loss), whether or not the partner is a service provider
  - <u>Rule #2</u> -- a service provider's receipt of an interest in future partnership profits with no current liquidation value (a carried interest or CI) is generally not taxable – rather the service partner reports income as recognized under Rule #1
- Proposals for change have focused on changing Rule #1, not Rule #2

CI Proposals

- House passed bills in 2007, 2008 and 2009: 100% of CI earned by partner performing services for partnership engaged in investment or real estate activities taxed as ordinary income (OI)

- House passed bill in 2010: 75% of such CI (50% in 2011 and 2012 transition period) taxed as OI, with the balance treated as flow-through under Rule #1

- Senate did not pass any CI bills, but did consider a bill that would have taxed 75% of such CI (50% for CI related to certain assets held at least 5 years) as OI, with the balance treated as flow-through under Rule #1

- Obama Administration 2010 and 2011 budgets: 100% of CI earned by a service provider taxed as OI, without regard to nature of partnership's activities
  - In contrast to Congressional proposals, the Obama Administration 2010 and 2011 budget proposals would have applied to service providers in all partnerships, not merely those providing services to investment and real estate partnerships
- Obama Administration 2012 budget (released last week): 100% of CI earned by partner providing services to an investment or real estate partnership taxed as OI
  - Adopts the more limited scope of Congressional proposals
  - Partnership covered only if "the majority of its assets are investment type assets"

Outlook

- Will CI proposals have any traction in 2011-2012?
  - Obama Administration continues to support treating CI as OI in 2012 budget
  - Continuing need for revenue
  - Democratic-controlled Senate did not pass previous CI bills
  - House, which passed CI bills 4 times while controlled by Democrats, is now controlled by Republicans

Details – Actual Proposals Very Complex

- Proposals generally include as CI, gains realized by a service provider as a result of (i) partnership-level sales of assets, (ii) partnership distributions of assets in-kind to partners, or (iii) sales by a partner of a partnership interest
  - Treating gain from the sale of partnership interests as CI has been criticized as over-inclusive, to the extent that it includes gain attributable to the enterprise value or goodwill of an investment management business (as opposed to built-in gain in underlying investment assets)
  - The 2010 Senate bill offered a lower rate for gains attributable to certain assets, including investment management company goodwill, held or deemed held for at least 5 years, so that only 50% of such gains would have been treated as OI

- CI proposals generally do not change the flow-through tax treatment of items attributable to a service provider's invested capital
  - Obama 2012 budget proposal would limit this exception to situations where the partnership "reasonably allocates" its income and loss to service provider's invested capital and other interests
  - Congressional proposals limited carve out to situations where the service provider's capital generally receives allocations on same basis as capital provided by unrelated investors (with certain exceptions allowing GP to not charge itself management fees or CI)

- No credit under the CI proposals for invested capital where capital contributions made with loan borrowed from, or guaranteed by the partnership or a partner
  - Even where loan is recourse with arm's length interest; or from fellow service provider; or from family member
  - Borrowed capital limitation goes well beyond need to prevent avoidance of CI rules through use of non-recourse loans structured to resemble CI economics

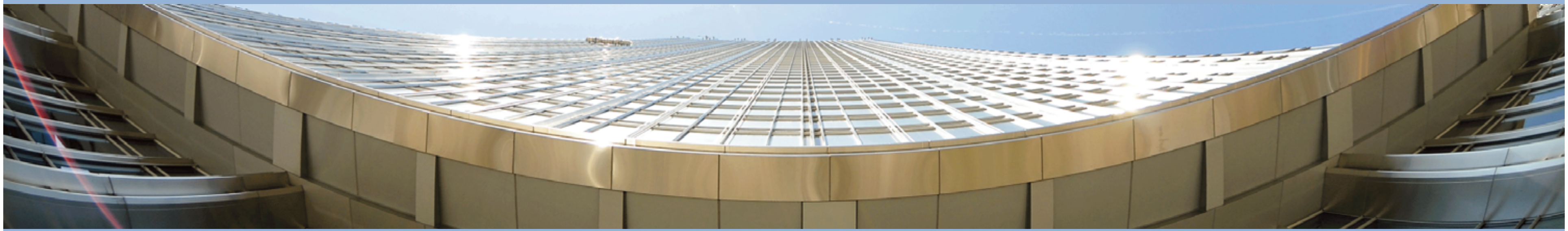
- Narrow definition of invested capital means that proposals may treat as CI income and gains not traditionally thought of as CI

- Narrow definition of invested capital creates risks for certain family investment partnerships, where no unrelated investor provides capital
  - 2010 Senate bill had an exception for partnerships where all allocations and distributions based on invested capital, but exception applied only where partnership did not invest in any other partnership that provided for a CI (even if such other partnership was unrelated and the CI was not paid to any family member)

- Scope of CI proposals -- applicable to CI in all partnerships or only to CI in investment and real estate partnerships?
  - In contrast to its prior budgets, Obama Administration 2012 budget limits CI proposal to interests in investment and real estate partnerships, consistent with prior Congressional proposals
  - 2012 budget provides partnership covered by the proposal only if a majority of its assets are investment-type assets – may reduce risk CI proposals could apply to interests in operating partnerships with some investment assets
- Blended Rate on CI?
  - Obama Administration 2012 budget would treat 100% of CI as OI
  - Most recent Congressional proposals would have a blended rate with 50%-75% of CI treated as OI and the rest treated as a flow-through under Rule #1

- Under proposals CI treated as OI would also be subject to self-employment taxes
  - Any CI given flow-through treatment would generally be subject to 3.8% medicare tax on passive income, beginning 1/1/2013 to the extent consisting of capital gains, dividends and interest, etc.

QUESTIONS?



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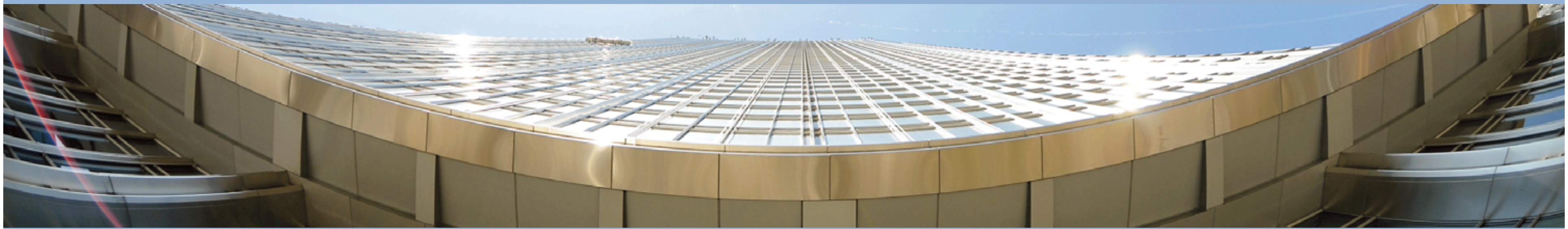

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