KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

December 13, 2011

Private Funds with Euro Exposure Face New Currency-Related Considerations

PENpoints

Addressing currency issues in advance of a possible Euro meltdown may mitigate the risks of the uncertain application of various jurisdictions' governing laws as well as investor discord over choice of replacement currency.

The European sovereign debt crisis and possible Euro instability raise a number of operational issues for private investment funds that are Euro-denominated, make Euro-denominated investments or otherwise have significant economic exposure to the Euro.

The manager of any private fund with Euro exposure should consider the following:

1. **Fund's denomination and functional currency.** The manager of a Euro-denominated fund or a fund with Euro-denominated capital contributions, distributions and/or reporting may be most directly impacted by the Euro's current risks and thus should assess its ability to re-designate the fund's functional currency and the numerous related operational implications of doing so.

The manager should also consider:

- whether to amend the fund's partnership agreement either to re-denominate its functional currency now or authorize the general partner to re-denominate the fund in the future, and
- the alternative currency and conversion ratio that would be most appropriate, as well as the investor approvals, if any, required for such redenomination.

Addressing currency issues in advance of a meltdown situation may mitigate the risks of the uncertain application of various jurisdictions' governing laws as well as investor discord over choice of replacement currency.

2. **Adequacy of risk disclosures.** A private fund manager engaged in fundraising should evaluate the adequacy of its disclosures regarding Euro-related risk, including whether supplemental disclosures should be included in offering materials and other filings, such as the manager's Form ADV, as to, e.g., the potential impact of currency instability or failure on the fund and its portfolio investments, and the cost of efforts to manage those risks.

3. **Ability to engage in currency hedging transactions.** A private fund is often permitted to enter into bona fide hedging transactions in connection with the acquisition, holding or disposition of a portfolio investment (but not for speculative purposes). The manager should review fund agreements to determine if they permit the fund to engage in currency hedging transactions, both in connection with a specific investment and the operation of the fund and if not, whether to amend its agreements to include and/or expand upon such provisions in the governing documents. Having broad, express authority to engage in currency hedging may provide the fund manager with critical tools for protecting the fund and its investments against foreign currency exchange-rate volatility.

4. **Economic treatment of currency hedging transactions.** Amounts paid or losses incurred by a fund in connection with hedging a portfolio investment are often treated as a fund expense with respect to the related portfolio investment, and any resulting distribution is treated as current income from that investment. The manager should consider how such amounts should be allocated when multiple portfolio investments are hedged through a single currency transaction or program, as well as how any non-investment-specific hedging transactions are treated.

5. **Ability to engage in other currency-related transactions.** The manager should consider what other currency-related provisions may be prudent or helpful to include in its fund agreements. For example, the manager may find it helpful to include express

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authorization to exchange any Euros held by the fund into non-Euro currencies and vice versa.

6. **Possible amendments to fund agreements.** In connection with reviewing and assessing potential changes to currency-related provisions in fund agreements, the manager should be mindful of any required investor and/or advisory board consents, particularly whether any such changes would trigger special consent thresholds applicable to changes affecting investors' capital commitments and/or liability. In connection with this assessment, the sponsor should review related subscription agreements and other ancillary agreements (side letters, advisory agreements, etc.).

7. **Assessment of portfolio exposure and fund counterparty risk.** The manager should consider conducting additional risk assesments or "stress testing" of its investment portfolio to gauge exposure to Euro currency volatility. For some managers, sophisticated currency movement sensitivity analysis may already be a routine part of risk monitoring; for others, enhanced monitoring of these risks may be helpful to better understand and manage Euro exposure, including through hedging and making appropriate risk disclosures to investors. In connection with this assessment, the manager should also evaluate exposure to European financial institutions, whether in the form of bank deposits, derivatives exposure or otherwise, and may want to consider whether further counterparty diversification would be prudent.

8. **Increased investor attention.** While we are not yet aware of a shift away from Euro-denominated funds — indeed sponsors of Euro-denominated private equity funds have had notable 2011 fund-raising success — anecdotal reports indicate that both general partners and limited partners are now spending significantly more time discussing the impact of the macro-economic environment and the European sovereign debt crisis. Accordingly, a general partner should be prepared to answer questions from investors regarding potential effects of currency movements and risks on the operation of its private funds and the execution of its investment program.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland author or your regular Kirkland contact.

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IRS Proposed Regulations Relax Hurdles to Sovereign Wealth Fund Investments in Private Funds

PENpoints

The IRS recently issued proposed regulations which should make an investment in a U.S. private equity fund more attractive to a sovereign wealth fund.

On November 2, 2011, the IRS issued pro-taxpayer proposed regulations (the "Expanded SWF Rule"), upon which taxpayers are immediately entitled to rely, relaxing U.S. tax hurdles that have long deterred a sovereign wealth fund ("SWF") controlled by a non-U.S. governmental entity from investing in a U.S. private equity fund.

Under Section 892 of the Code, non-U.S. governmental entities are generally exempt from U.S. federal tax on U.S. source income and gain from investments in debt instruments, stocks, and other securities (the "892 Exemption").

The long-standing prior version of the Section 892 regulations (the "Old SWF Rule") generally exempted an SWF (or other entity controlled by a non-U.S. government) from U.S. tax on much of its U.S. source income and gain from investments in securities, but only as long as it did not earn any (even $1 of) income from "commercial activity" – whether earned directly by the SWF or indirectly through a private equity fund in which it was a limited partner.

In other words, the Old SWF Rule caused an SWF with any commercial activity income — whether in the U.S. or anywhere else in the world — to lose, perhaps permanently, its 892 Exemption.

This aspect of the Old SWF Rule has been especially troublesome for an SWF investing as a limited partner in a U.S. private equity fund with commercial activity income. Because a portion of the fund's commercial activity income was attributed to the SWF limited partner, the SWF would, without careful structuring, lose its 892 Exemption, potentially exposing the SWF to U.S. tax on all of its U.S. source income, including the SWF's share of all income and gains from investments in securities, realized directly or through private funds. As a result, in order to protect its eligibility for the 892 Exemption, an SWF typically sought to impose restrictions (e.g., a prohibition on all "commercial activity") on each private fund in which the SWF invested and often demanded complex structures (such as "blocker" corporations).

The Expanded SWF Rule allows an SWF to invest in a private fund as a limited partner without losing its 892 Exemption. Under the Expanded SWF Rule, an entity controlled by a non-U.S. government (such as an SWF) does not entirely lose its 892 Exemption solely because it is a limited partner in a partnership (such as a private fund), so long as the SWF does "not have rights to participate in the management and conduct of the partnership's business" under the partnership agreement or the law where the partnership is organized, other than consent rights over "extraordinary" events (e.g., partnership dissolution).[1]

Thus, under the Expanded SWF Rule, while the SWF's share of the partnership fund's U.S. commercial activity income continues to be taxable in the U.S., the SWF's share of the partnership's non-commercial-activity income (such as income and gains from U.S. securities) is not so taxable.[2]

Although the IRS indicated that taxpayers may immediately rely on the Expanded SWF Rule, SWFs are likely to be reluctant to do so until the IRS has actually finalized the Expanded SWF Rule, just in case the IRS ultimately changes the proposed rule's scope.

Promulgation of the Expanded SWF Rule is a taxpayer-friendly development that should make a limited partner investment in a U.S. private equity fund more attractive to an SWF (or other entity controlled by a non-U.S. government) by eliminating the previous harsh rule that an entity's limited partnership investment in a private fund with commercial activity income causes the SWF to forfeit, perhaps permanently, its 892 Exemption with respect to (e.g.) income and gains from investments in securities.[3]

1 Whether an SWF's participation on a fund's investment or advisory committee constitutes participating in the fund's management is unclear.

2 Under the Expanded SWF Rule, an SWF's limited partner share of a private fund's profits from securities "trading" for the fund's own account is not treated as taxable commercial activity income (so long as the fund is not itself a "dealer" in the traded securities) and hence is not taxable in the U.S.

3 In addition to liberalizing U.S. tax law with respect to an SWF's limited partner investment in a U.S. private equity fund with commercial activity income (as described in text), the Expanded SWF Rule also contains several liberalizations for activities conducted directly by an SWF (or other entity directly or indirectly controlled by a non-U.S. government), e.g., repealing the old harsh rule relating to the disposition of a U.S. real property interest, now treating such a disposition as not itself constituting the conduct of a commercial activity.

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PENbriefs

Forward-Looking Statements – Deal Market Trends for 2012

In this recent *M&A Update*, we take a look back at 2011 for lessons learned in the M&A market and implications for the coming year.

United State Expands Iran Sanctions

The United States recently imposed new sanctions In an effort to prevent Iran from developing nuclear weapons and supporting international terrorism, raising new compliance challenges for U.S. and non-U.S. entities engaged in international trade and investment.

To learn more about these sanctions and their effects on such entities, see our recent *Kirkland Alert*.

PENnotes

2012 PLI's Real Estate M&A and REIT Transactions
New York, New York - Live via Webcast
January 12, 20112

Kirkland & Ellis partner Edward Schneidman will participate in PLI's Real Estate M&A and REIT Transactions 2012, scheduled for January 12, 2012 in New York and via live webcast. The program will take an in-depth look at some of the transactions completed in 2011, and will explore the structures, legal frameworks and dynamics of the current environment, including strategies for restructuring real estate portfolios and companies in and out of bankruptcy; for successfully identifying and executing transactions; and for raising new capital, through equity offerings and other means. Click here for more information about the New York event or for information about the live webcast.

American Securitization Forum 2012
Las Vegas, Nevada
January 22-25, 2012

Kirkland & Ellis is an associate sponsor of ASF 2012, which attracts the securitization industry's top professionals. ASF 2012 will build on the success of last year's conference, with over 4,500 participants expected. Conference attendees will participate in sessions on relevant industry topics presented by the top industry executives. Click here for more information or to register for this event.

The 18th Annual Columbia Business School
Private Equity and Venture Capital Conference
New York, New York
February 3, 2012

Kirkland & Ellis is a sponsor of the Columbia Business School Private Equity and Venture Capital Conference, which will bring together alumni, professionals and students for informative discussions on recent opportunities and challenges that have emerged in the private equity and venture capital industries. Click here for more information or to register for this event.

Kellogg Private Equity Venture Capital Conference, Finding Growth in the Next Generation"
Chicago, Illinois
February 15, 2012

Kirkland & Ellis is a sponsor of the Kellogg School of Management's 13th Private Equity and Venture Capital Conference, "Finding Growth in the Next Generation." The conference brings together some of the biggest names and brightest minds in the fields of private equity and venture capital to discuss the opportunities and challenges facing the industry. This year's conference will provide a forum for private equity investors, venture capitalists, entrepreneurs, and LPs to discuss how the next generation of funds will find growth and ultimately drive returns for investors. Attendees will have the opportunity to gain insights, pose questions and network with leading investment professionals representing a diverse group of firms, markets and geographies. More information to come.

18th Annual HBS Venture Capital and Private Equity Conference
Boston, Massachusetts
February 17-18, 2012

Kirkland & Ellis attorneys, Kirk Radke, Anup Sathy and Karyn Koiffman will be panel participants for the 18th Annual HBS Venture Capital and Private Equity Conference. More information to come.

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Private Equity Practice at Kirkland & Ellis

Kirkland & Ellis LLP's nearly 400 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named Best M&A Firm in the United States at World Finance's 2011 Legal Awards and was honored as the "Private Equity Team of the Year" at the 2011 IFLR Americas Awards. Kirkland was also recognized as "Law Firm of the Year" for Private Equity by *U.S. News & World Report "Best Lawyers"* 2011-2012 and "Law Firm of the Year" in *Buyouts* magazine's "2010 Deal of the Year Yearbook." Kirkland was ranked in the first tier among law firms for both Private Equity Buyouts and Private Equity Funds by *The Legal 500 U.S. 2010*. Additionally, *Pitchbook* named Kirkland as one of the most active law firms representing private equity firms in its 2010 "Private Equity Breakdown."

The Lawyer magazine recognized Kirkland as one of the "The Transatlantic Elite" in 2008, 2009 and 2010, noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

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