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Redemptions from Failed Hedge Funds: How Should They Be Treated by the Courts?

Although hedge funds have demonstrated significant growth in size and investment activity, several funds such as Bayou Group, Manhattan Investment Fund, Amaranth Advisors LLC and Marin Capital have recently experienced high-profile collapses. These cases have led to either the appointment of a receiver or the institution of bankruptcy proceedings, with a trustee charged with the duty of unraveling the affairs of the hedge fund.

There are two key issues that habitually arise in the administration of a failed hedge fund. The first is the treatment of investors who redeemed their interests in the fund prior to its failure and, as a result, received a greater return than those who remained invested until the fund failed. The second is the calculation of investor distributions upon the liquidation of the fund's remaining assets. Courts and interested parties continue to wrestle with determining the appropriate approach to these issues but there is no consensus on the best way to address them.

The Nature of Hedge Fund Failures

While each failed hedge fund has facts and circumstances that make its demise somewhat unique, the failures can be grouped into three general categories.

- **Business Failures.** Some hedge funds fail because they make bad investments and lose too much money to survive. This may be the result of bad initial strategy or the poor execution of a viable investment plan.
- **Outright Fraud.** A number of hedge fund failures are attributable to intentional fraud by the fund's principal or manager, which commenced at or near the inception of the fund. Several have been classic Ponzi schemes in which funds collected from new investors were used to pay dividends to earlier investors. This created the appearance of a profitable entity while, in fact, investor monies were misdirected and used for a variety of improper purposes, including payments to the fund managers. In those cases, little or none of the money invested was ever put into investments.
- **Hybrid Cases.** The last general category includes cases in which the fund managers invested funds as advertised and also diverted money in excess of approved fees. In these cases, the collapse of the fund is often attributable to both bad investments and diversion of funds.

Redemptions

When a declining hedge fund reports diminishing returns, investors often seek to redeem their investments (*i.e.*, withdraw). In the cases of hedge funds that are troubled or, even worse, fraudulently managed, the promoters often allow redemptions calculated upon either the original amount invested or upon some other invented amount unrelated to the value of the fund, but intended to create the impression that the fund is doing well. When the funds

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subsequently fail, two issues arise regarding the prior distributions. First, whether and to what extent an investor should be permitted to retain the previously received redemptions. Second, how should such redemptions be treated for the purpose of calculating post-failure distributions?

The principal legal theory utilized to recover improperly-paid redemptions is that of fraudulent conveyance. Such actions seek to recover property improperly transferred in order to preserve assets for the benefit of creditors. In an effort to allow creditors to receive the largest dividend possible under the circumstances, and to prevent debtors from "selling" property at less than fair prices either through greed or desperation, transfers by an insolvent transferor are scrutinized to make certain that the estate has not been depleted by fraudulent or ill-considered transactions.

Fraudulent conveyances fall into one of two categories. The first requires intentional fraud. In such cases, property is transferred for little or no value with the actual intent on transferor's part to defraud, hinder or delay creditors. This form of fraudulent conveyance is readily understandable.

Less obvious is the second form of fraudulent conveyance: constructive fraud. Here, actual intent of the transferor is not required. Instead, a transfer is deemed to be a fraudulent conveyance if it is made while the transferor is insolvent (or about to become insolvent) and the value received is less than "fair" or does not constitute "reasonably equivalent value." In order to determine whether a "constructive" fraudulent conveyance occurred, the court must retrospectively determine the value of the asset transferred and then compare it to the consideration received at the time of the transfer.

Under either form, a recipient of a fraudulent conveyance who takes in good faith and for value retains a lien on property would receive up to the value of the property which they exchanged in return for the fraudulent conveyance. Experience teaches that most investors who receive redemptions take them in good faith. Therefore, a receiver's challenge is almost always based on a dispute over the value of the investment at the time of the redemption.

If a receiver chooses to seek recovery of redemptions under a fraudulent conveyance theory, he may proceed under either of the two theories. A receiver can proceed under the theory of actual fraud. If the fund operator was operating a Ponzi scheme or was otherwise engaged in an actual fraud at the time of the redemption in question, and if the redemption was made in an effort to conceal the fraud or to encourage others to invest, then the receiver may seek recovery of all of the funds transferred as a result of the redemption subject only to the good faith defense. Alternatively, if the receiver proceeds under a constructive fraudulent conveyance theory, he will seek the difference between the value of the property received by the estate and the value of the property conveyed.

Actions To Recover Redemptions

Almost all of the judicial analysis related to the propriety of a receiver's action to recover funds paid as distributions in advance of the collapse of a hedge fund has arisen out of cases in which the failed hedge fund was deemed to be a Ponzi scheme. In those cases, there was never a time when the enterprise was operating legitimately and there were no real earnings.

Fraudulent conveyances fall into one of two categories. The first requires intentional fraud. Less obvious is the second form of fraudulent conveyance: constructive fraud.

Courts faced with claims by receivers for the return of amounts paid to investors prior to the collapse of the fund generally have been required to undertake their analysis in the context of fraudulent conveyance law. Receivers have argued that the redemptions constituted intentional fraudulent transfers because they were made in furtherance of the Ponzi scheme and constructive fraudulent transfers because the redeeming investors received more than they were entitled to as the value of their investments was less than the amount received.

Courts generally have sided with the redeeming investors in the Ponzi scheme context. They have reasoned that since the Ponzi scheme was a fraud from its inception, the original investment was void *ab initio*, giving rise to a claim for rescission. Thus, the courts reason, an investor has given fair value

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by exchanging a valid rescission claim for the redemption. The extinguishment of a valuable rescission claim, therefore, is deemed a good faith exchange for value and accordingly is immune from attack as a fraudulent conveyance. The value of the rescission claim is deemed to equal the amount initially invested. Under this approach, however, funds received in excess of the initial investment (*i.e.*, profits) must be returned because the amount of the valid rescission claim is limited to the original investment.

In analyzing this judicial reasoning, it should be noted that, in cases of this type, the investors have not asserted a rescission claim at the time of the redemptions. The "exchange" which they intended to make was merely a redemption of their interests in an investment. Releases, which would be expected in the case of a settlement of a rescission claim, were not exchanged. In fact, the investors likely had no knowledge of any basis for rescission. Therefore, the extinguishment of a rescission claim as the basis for a fair value exchange is a legal construct created to justify the result of allowing a redeeming investor to keep money received. The investor sought to redeem its investment, not to rescind its original transaction. Thus, in order to determine whether the exchange was proper, the value of the investment should be calculated in accordance with the operative documents governing the hedge fund and then compared to the amount received.

These documents can take one of two forms. The first form treats the investment as a loan with a promised return of principal plus interest. Here, if the amount returned is equal to the contractual amount, it can be fairly argued that the exchange is for reasonably equivalent value. But under such circumstances, it should be unnecessary for the court to involve the fictional "rescission claim" analysis to protect the transfer. Moreover, even under these circumstances, where the contract is clear, courts have been unwilling to allow the investor to keep the interest component. Thus, it appears that the court, in utilizing the rescission theory, is attempting to achieve a form of rough justice regardless of the provisions of the parties' agreement.

This conclusion is further supported by the court's treatment of the second and more prevalent arrangement in the hedge fund cases. Under this argument, the investor is assigned a percentage interest in the fund which fluctuates as new investors contribute to the fund and as the value of investments rise and fall.

In the typical fraud case, whether Ponzi or hybrid, the value of the enterprise has been diminished by the fraud and, therefore, the value of the shares redeemed also has been reduced. Thus, any payment in response to a redemption request exceeding this reduced value is, by definition, a constructive fraudulent conveyance.

Some have argued that the prevailing judicial view holding that the release of a rescission right constitutes value sufficient to support the redemption in the Ponzi scheme context is flawed because it places an unrealistic value on the rescission claim. While the courts may be correct that the investor has a valid claim for rescission in the full amount of its investment, they fail to consider the *value* of that claim in the context of an insolvent entity, nor do they consider the impact of this decision on the underlying rationale of the fraudulent conveyance statutes.

Courts have suggested that the use of fraudulent conveyance law to redistribute losses among investors is really a disguised preference analysis, which is only available under the Bankruptcy Code. In a preference recovery, payments on account of an antecedent debt within a prescribed period are subject to recovery where such payments allow the recipient to receive more than one would receive if the insolvent payor

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were liquidated. Since legislators have not extended preference liability beyond bankruptcies, the courts further suggest that an extension of this form of analysis really is a veiled attempt to create a cause of action not yet approved by the legislature. Instead, the courts have focused on a transaction-by-transaction analysis, ignoring the comparative recovery aspect mandated by a preference analysis. The clear conclusion is that if the redemption is valid and proper under the governing documents, then the redemption is supported by fair consideration. It appears that the prevailing view is correct, at least with regard to any argument based upon comparative recovery among claimants.

But, to the extent courts create the fiction of a rescission claim to support the redeeming investor over those left behind, the courts have committed the very wrong they criticized in rejecting comparative recovery arguments; they have effectively made a policy decision better left to the legislature. At the time of the redemptions in question, every investor in the scheme held an equally valid unasserted rescission claim. It is only by fortuity that some investors sought redemption prior to the collapse of the scheme while others did not. Moreover, the redeeming investor did not even assert a rescission claim. By recharacterizing the nature of the redemption, the courts have chosen to ignore the transaction that actually took place. The only possible purpose for such analysis is to achieve a goal not mandated by the legislature.

If such transfers are viewed for what they were intended to be — redemptions of interests in the enterprise — the redeeming creditor has received far more than the value exchanged. The recharacterization of redemptions as rescission settlements only serves to benefit those who, through luck, avoided the consequences of the fraud by receiving money taken from subsequent investors. While those who received the funds did so innocently, their innocence should not create sufficient reason to allow them to receive a better result than other victims of the same scheme.

Distribution to Investors

In contrast to the court's limited consideration of the various theories of recovery from redeeming investors, courts have developed four theories to guide the distribution of recovered funds.

The first method is the "*Pro Rata* Distribution" method, which ignores redemptions. A receiver returns to each investor the amount invested by that investor, divided by the total amount invested, multiplied by the dollars to be distributed. While this method is often discussed by courts, its failure to make allowance for previous distributions has led to its universal rejection.

A second distribution method is commonly known as the "Net Investment," "Net Principal Investment" or "Franklin" method of distribution. Here, redeeming investors are allowed to retain all funds distributed to them, but those amounts are deducted from the investor's initial investment before calculating its recovery. The "net investment" then is used to calculate the investor's share of the pool of recovered funds. Courts rejecting the net investment method have found that it results in certain investors receiving more than their proportionate share of recovered funds at the expense of the other, less fortunate, investors, thereby violating the principle of unjust enrichment.

Regardless of the distribution theory adopted, its fairness is clearly compromised in cases where the fund commences and operates as a legitimate enterprise and fraud or malfeasance occurs at a later date.

The "Rising Tide" method is a third approach to distribution. Pursuant to this distribution methodology, the investor is entitled to retain previously received funds, but they are deducted from the amount that he would have received under the distribution plan, not from his original investment. The formula to be applied under this method is dollars invested, multiplied by proposed distribution percentage, minus amount redeemed. Courts adopting this method suggest that it is more equitable for those who did not redeem or only redeemed small amounts. They suggest that by directing all funds remaining in the pool to non-redeeming investors until cash payouts are equalized, the Rising Tide method comes closer to equality than the others previously discussed.

A fourth distribution method discussed is the "Redemption Recapture" method. Under this methodology, the receiver seeks to recover all redemptions, place them back in the distribution pool and redistribute the funds based on the investor's original investment. The receiver in the Bayou Hedge Funds bankruptcy cases proposed to adopt this method. In that case, Bayou's principals operated a massive Ponzi scheme, and upon collapse, the sole remaining estate assets consisted of investor redemptions. Recognizing the substantial costs involved in litigating over one hundred redemption adversaries, the Receiver devised a distribution process that contemplated the return of prior redemption payments and the distribution of such recoveries to all investors. Notwithstanding the actions of the receiver in Bayou, to date, no court has adopted the "Redemption Recapture" method.

An Alternative Distribution Method

The methods discussed above are based on the presumption that the hedge fund in question must be treated as a blind pool. That is, every dollar contributed, regardless of timing, is treated the same as every other dollar. This concept was developed in the context of true Ponzi schemes, where funds were never invested and all investors were victims separated only by the fortuity of when they unknowingly invested in the fraudulent enterprise and if they requested redemptions prior to the scheme's collapse.

> *The rise in importance of hedge funds, along with their increased rate of failure, has exposed the lack of rigor in the prior legal analysis of the claims of investors in failed hedge funds.*

Regardless of the distribution theory adopted, its fairness is clearly compromised in cases where the fund commences and operates as a legitimate enterprise and fraud or malfeasance occurs at a later date. Under any distribution theory, courts should make a distinction in calculating losses for investors depending on the value of their interests at the time the fraud commenced.

By way of illustration, consider the following simple example: Investor A contributes $100,000 to a $1,000,000 fund. Thus, at the time of his initial investment, he owns 10% of the fund. Over the first year, the fund increases in value to $10,000,000. Investor A's 10% percent interest is now worth $1,000,000. At the end of the fund's first year, Investor B contributes $100,000, the same investment as Investor A. Should he now have the same 10% interest as Investor A? Clearly not. Instead he owns .09% of the fund. The value of his investment equals the $100,000 he contributed as opposed to $1,000,000.

If a fraudulent scheme later commences at the hypothetical fund and the fund is liquidated, the distribution plan should consider the investor's percentage interest in the fund as opposed to the raw dollars invested.

Similarly, if the value of the fund had decreased due to unsuccessful investing, the value of each investor's investment should be adjusted downward. Thus, if we modify the prior example to reflect performance in which the initial market value of the investments had decreased from $1,000,000 to $500,000 at the end of year one, Investor A's investment would be worth only $50,000. If Investor B then contributed $100,000, his percentage interest would equal 16.67%. Simply put, the value of an investor's percentage interest in the fund should rise and fall with the value of the fund.

The most difficult question is whether and how to factor in the losses at a fund that are caused by fraud. As in the examples pertaining to investment loss, a person contributing $100,000 to a $1,000,000 fund owns 10%. If half of the fund is stolen and a new $100,000 investor comes in, a strict percentage approach would suggest that he would own one-sixth of the fund or 16.67% and the original investor would own one-twelfth or 8.34%. This result may seem inequitable to some, given that the fund made no real investments. Moreover, it could be argued that both investors were equally the victims of a fraud and should be treated the same. The methodology suggested herein, however, measures the actual losses suffered by each investor based upon the timing of their investments and the timing and extent of the thefts. Accordingly, it most accurately reflects the actual experience of each investor in accordance with the terms of their investment.

Conclusion

The rise in importance of hedge funds, along with their increased rate of failure, has exposed the lack of rigor in the prior legal analysis of the claims of investors in failed hedge funds. Applying the principles of fraudulent conveyance law while respecting the structure of the hedge funds leads to a fairer and more consistent distribution of the assets, regardless of the cause of the hedge fund's failure. Accordingly, whether it is for the purpose of determining the validity of redemptions or developing a plan of distribution, courts should analyze the position of each investor based on the value of its investment as of the fraud's occurrence (and thereafter if needed). Applying this overriding principle will result in more equitable treatment for investors.

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Investing U.S. Pension Plan Assets in Funds

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Over the years, U.S. pension plans have become a prime source of capital formation for investment partnerships, hedge funds, private equity funds and venture capital funds. Most fund managers understand that a federal statute – the Employee Retirement Income Security Act of 1974, as amended – exists, which impacts the viability of including pension plans as investors in their funds. Importantly, if U.S. pension plans are permitted to invest in funds, ERISA compliance is necessary to ensure that fund managers do not inadvertently assume ERISA fiduciary status with respect to those pension plans investing in funds.

Under U.S. Department of Labor Regulations, absent an exception, when a pension plan purchases an interest in an entity, such as a fund, that fund may be deemed to hold the underlying assets of the pension plan and, if so, will become subject to ERISA's fiduciary duties and prohibited transaction rules. If the fund were to become a fiduciary, it would have to act in the best interests (and for the exclusive benefit) of the pension plan participants, which could be different from the interests of the remaining investors in the fund. Obviously, this is something to avoid.

Most practitioners refer to these ERISA mandates, as set forth in the Regulations, as the "Plan Asset Rules." Compliance with the Plan Asset Rules or, more particularly, falling within an exception to the Plan Asset Rules, has been a necessary evil, but one with which funds and their counsel have been able to deal. Recently, Congress enacted pension reform legislation called the Pension Protection Act of 2006 (the "2006 Act"), which revises some of the rules relating to the investment of pension plan assets. For those funds that have not yet evaluated the 2006 Act's impact, it may be time to do so.

Under the U.S. Department of Labor's existing regulations, there are exceptions to the Plan Asset Rules. One such exception applies to funds in which "benefit plan investors" hold less than 25% of the value of any class of equity interests (the "25% Rule"). Importantly, prior to the enactment of the 2006 Act, benefit plan investors included plans subject to ERISA, IRAs, foreign plans, governmental plans and church-sponsored plans. This very broad definition of "benefit plan investors," fundamentally, made the 25% Rule difficult, if not impossible, for most funds to satisfy. As a result, funds have either had to preclude "benefit plan investors" or, alternatively, seek to comply with one of the other exceptions contained in the Plan Asset Rules, most likely the Venture Capital Operating Company Exception or the Real Estate Operating Company Exception (the "VCOC" or "REOC" exceptions).

The rules applicable to VCOCs and REOCs, however, impose certain obligations on the part of funds; for example, a fund must obtain contractual rights to substantially participate in, or substantially influence, the management of portfolio companies, and must affirmatively exercise those rights in the ordinary course of its business with respect to at least one of the portfolio companies. To satisfy the management rights criteria, funds generally retain the right to appoint one or more directors to a portfolio company's board of directors.

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If, however, a fund is eligible to rely on the 25% Rule, then the stringent rules that apply to VCOCs and REOCs can be avoided. Under the 25% Rule, as amended by the 2006 Act (the "new 25% Rule"), a fund must ensure that no more than 25% of the investors are private U.S. corporate retirement plans, IRAs, church-sponsored plans (subject to ERISA) and certain labor union/multiemployer pension plans (also referred to as Taft-

However, because non-ERISA investors are no longer included in the 25% determination, it may be much easier for those funds to increase capacity for non-ERISA pension fund investors and, thus, expand the types of entities that may be able to participate in the funds.

Hartley plans). Plans mandated or sponsored by federal, state and local governmental entities, foreign pension plans, foundations and endowments, and certain other non-ERISA retirement plans are no longer included within the 25% Rule. As a result it may be easier for funds, including buyout and venture capital funds, which were previously unable to satisfy the old 25% Rule (and therefore had to rely on the VCOC and REOC exceptions), to now fall within the revised 25% exception.

Funds currently structured as VCOCs or REOCs may now wish to satisfy the new 25% Rule and, through the new 25% Rule, avoid the application of the Plan Asset Rules. In evaluating the viability of the new 25% Rule, funds should consider a number of issues:

- The calculation of the percentage of benefit plan investors must be determined at the time of acquisition of any equity interest in a fund. Acquisition is broadly defined to include an increase in ownership interest resulting from a redemption of another investor's interests and is determined on a class-by-class basis.

- A fund may wish to examine the status of its existing investors to determine, whether under the new 25% Rule, benefit plan investors represent less than 25% of each class of securities.

- Funds should consider whether the new 25% Rule may be preferable to the requirements set out under the VCOC or REOC rules. Depending upon the type of fund and the stage of a fund's life cycle, the 25% Rule may or may not be appropriate. For example, funds in a capital-raising mode may want to retain absolute flexibility. If so, they may conclude that it is not prudent to limit benefit plan investors. However, funds that are fully invested, or close to a distribution period, may find that it is no longer necessary to satisfy the VCOC or REOC compliance rules and can fall within the new 25% Rule.

- As noted, the 25% Rule is measured upon each acquisition of an equity security; therefore, fund sponsors must have the ability to monitor withdrawals, transfers and new investors to ensure compliance.

- Funds should review all documents and associated agreements to identify any affirmative contractual obligations or commitments pertaining to VCOC or REOC status. A fund may determine that the 25% Rule is impermissible under its contractual commitments, which might therefore require investor consents to change the form of ERISA compliance.

- Credit agreements and other third-party agreements may also impose contractual obligations and require specific compliance with certain of the Plan Asset Rules. Those contracts should also be reviewed.

Previously, some funds were unable to qualify as VCOCs and REOCs, and, as such, had to satisfy the old 25% Rule. However, because non-ERISA investors are no longer included in the 25% determination, it may be much easier for those funds to increase capacity for non-ERISA pension fund investors and, thus, expand the types of entities that may be able to participate in the funds. Those sponsors who, up to now, have relied upon assuring that employee benefit plan investors are under 25% of the total investors in the fund may wish to review their existing investors to determine which portion of the existing investors are governed by the new 25% Rule, and which percentage are non-ERISA employee benefit plan investors.

Fund sponsors, if they have not already done so, should consider the impact of the new 25% Rule as they structure any new funds. Some funds, for example, traditionally have segregated ERISA plan investors into a single vehicle intended to qualify as a VCOC, while other non-ERISA investors have invested through a parallel vehicle. That may no longer be necessary since the Pension Protection Act of 2006 allows funds greater flexibility in the types of investors.

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Should Sovereign Wealth Funds be Regulated? (*Part 1*)

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Judging by the most hotly contested issue that dominated the agenda of the World Economic Forum held at Davos, Switzerland in January 2008, the concern over the regulation of private investment funds, such as hedge funds and private equity funds, which has received considerable attention in both Europe and the United States over the past few years, has been eclipsed with the emergence of a perceived new threat emanating from so-called "sovereign wealth funds" or SWFs. Categorized by their critics as the "barbarians at the gate" of the international financial system and hailed by their proponents as the "white knights" of the global current sub-prime economic crisis, their systemic significance is undeniable. Current projections indicate that by 2015, SWFs will have some $12 trillion worth of assets under management. The size of the seven largest SWFs (often termed the "Super Seven"), whilst remaining relatively small when compared as a percentage of total global financial assets (totaling an estimated $167 trillion), dwarfs that of private investment funds as evidenced by their estimated current assets under management:

Abu Dhabi Investment Authority (UAE)	$875 billion
Government of Singapore Investment Corporation	$330 billion
Government Pension Fund of Norway	$322 billion
Kuwait Investment Authority	$250 billion
China Investment Corporation	$200 billion
Stabilization Fund of the Russian Federation	$127 billion
Singapore's Temasek Holdings	$108 billion

What are SWFs and what are the reasons for their new found prominence?

SWFs constitute dedicated government-owned investment vehicles designed to invest government savings in a variety of cross-border financial assets in private markets. Despite their new found prominence, SWFs are not a new phenomenon — several have been in existence since the early 1950's and 13 of the 20 largest SWFs were formed prior to 2000. Traditionally SWFs have been used as a tool of national governments to deal with excess cash derived from trade surpluses. That cash was often invested in liquid, risk-averse, low-yielding assets (such as U.S. Treasury Bonds), either to enable speedy utilization for macroeconomic requirements, such as dealing with boom-bust cycles in the case of oil and commodity-dependant export economies (generally termed "stabilization funds"), or alternatively to provide for assets to cover future state liabilities such as pension and healthcare (generally termed "intergenerational funds"). In recent times, however, the size of SWFs has grown exponentially with the result that there is now considerable excess capital available in the case of many Asian countries, based on export driven trade surpluses, and in the case of Russia and the Middle East, spiraling oil and natural gas prices. The sheer growth in the size of such capital has prompted a review of the risk profile of the investments into which it has traditionally been invested. Generally, diversification is also seen as un-avoidable given the sheer scale of growth. Certain projections indicate that SWFs would still have considerable excess capital available for investment even if they acquired in a single year all the net annual issuance of traditional SWF investments such as U.S. treasuries, EU government securities and U.K. treasuries.

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investments. Generally, these investments have taken the form of direct investment in high-profile U.S. and European companies (for example, the $942.3 million acquisition by Istihmar, the Dubai SWF, of Barneys New York), indirect investment via private equity and hedge fund groups (most notably the $3.5 billion investment by the China Investment Corporation in the listed Blackstone Group), as well as, more recently, direct investment in Western banks and other financial service companies in the context of the sub-prime crisis (examples include the $5 billion investment by the China Investment Corporation in Morgan Stanley and the $11.5 billion investment by Singapore's Temasek Holding in UBS).

Why do SWFs generate so much controversy?

Critics of SWFs have two main concerns surrounding their rise to prominence.

First, there is the concern that investments made by SWFs might be motivated by strategic geopolitical, rather than commercial, reasons, for example, gaining access to sensitive technologies by investing in strategic industries such as defense, using the significance of large scale financial investments in a particular country as political leverage or investing to secure access to strategic commodities and resources such as oil. In the U.S. and Europe this fear derives primarily from the increased size and aggressiveness of SWFs operated by emerging geopolitical rivals such as China and Russia.

The political concern is not, however, entirely novel — there has been significant regulatory scrutiny in both the EU and the U.S. with respect to proposed investments by foreign companies from countries considered geopolitical rivals in industries considered strategically sensitive. Countries in the EU have traditionally dealt with this issue in a protectionist manner by allowing national governments to retain "golden shares" *(i.e.*, shares which provide the national government with a veto power with regard to important decisions, such as takeovers), setting caps on aggregate shareholding in strategic industries or subjecting any proposed foreign investment to a rigorous approval and review process by a government body. This is on the basis of "national security," often including a form of economic security aimed at protecting national champion companies and industries, although such protectionist provisions have come under increasing scrutiny from the European Court of Justice on the basis of the principle of freedom of movement of capital seen as one of the cornerstones of the EU common market. In contrast, the U.S. has traditionally adopted a more liberal policy, which requires the review and approval of certain foreign investments by the Committee on Foreign Investment in the United States ("CFIUS"), pursuant to the Exon-Florio Amendment to the Defense Production Act of 1950 ("EFA") on the basis of defined criteria that are more narrowly focused on national security, rather than broader economic or national interests. The fact, however, that SWFs are directly owned and operated by national governments means that the specter of geopolitical motivation looms considerably larger in such cases and this has elicited a review of whether existing measures provide sufficient safeguards.

Second, it is contended that the sheer size, coupled with the lack of transparency and accountability of SWFs, make them a systemic danger to the efficient operation of international financial markets and thus a prime case for regulation — effectively the same argument that has formed the foundation both in Europe and the U.S. of the move to greater regulation of private investment funds. This argument has merit, given that most SWFs are currently largely immune from direct or indirect domestic regulation (or, even if subject to domestic regulation, have a severe conflict of interest issue inherent in any such regulation), do not generally publish information concerning their size, investment strategy, track record, corporate governance structure or fiduciary controls (and in some cases are in fact prohibited by domestic legislation from revealing any such information), and, in some instances, lack the investment management experience necessary to deal with the complexities involved with investments of this scale and nature.

Should SWFs be regulated?

The political, transparency, accountability and systemic risk issues discussed suggest that a certain measure of regulation is required for the operation of SWFs, although the exact form and extent of such regulation is still the subject of considerable debate. This issue will be discussed in the second part of this article, which will be published in our September newsletter.

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Carried Interests: To Tax or Not to Tax, That Is the Question

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Under current tax rules, the receipt of a carried interest will not result in taxation upon receipt if properly structured as a "profits interest."

Okay, so I cheated a little, but hopefully it drew your attention. It is not whether, but when and how it will be taxed. But let's back up.

Carried Interest Defined

What is a "carried interest?" This is the name of an interest that private equity and hedge fund managers receive. Most private equity and hedge funds are set up as limited partnerships or limited liability companies. (I will call both "partnerships" throughout.) Most funds are structured to give the investors back their original investment plus a rate of return. Thereafter, the remaining profits are shared between the managers and the investors, with managers generally receiving somewhere between 15% and 30%. This amount is the "carried interest." You may have heard that some funds are structured with a "two and twenty" interest. This means that the managers earn a two percent management fee and a 20% carried interest in profits above a certain threshold.

Current System of Taxation

Under current tax rules, the receipt of a carried interest will not result in taxation upon receipt if properly structured as a "profits interest." A "profits interest" is an interest in a partnership that will give the owner of the interest absolutely nothing if, on the day he or she receives the partnership interest, the partnership's assets were sold at fair market value and the proceeds were distributed to the partners in complete liquidation of the partnership. For example, you and I set up a partnership. You agree to be the money partner (thank you) and I agree to contribute nothing but to work hard to make the money grow (you're welcome). If you contribute $100x and the partnership agreement provides that upon liquidation you receive $100x, I will receive nothing if liquidated on day one. I therefore have a profits interest and will not be taxed on receipt. Although I receive value, in the form of the ability to share in future profits, I will not be taxed because I receive nothing under this "liquidation analysis." (This is different than the receipt of common stock from a corporation, an important consideration when choosing an entity for a new enterprise.)

As a partnership earns income, all partners are taxed in the same way. If the partnership earns long-term capital gains, all partners have long-term capital gains (currently taxed at 15%).

In an environment where fund managers are taxed at 15% on millions of dollars for providing their management services but a regular employee, commission worker or broker is being taxed at ordinary income tax rates of 35%, it is no wonder why some politicians have concluded that the system is inequitable.

Proposals for Change

If one did want to "fix" this problem, how would one go about it? There are two main proposals under consideration. First, one could tax the fund manager upon the receipt of the "profits interest." Alternatively, one could tax the income received at ordinary income tax rates.

Turning to taxation upon current receipt, the IRS has argued this in the past and (gulp) won! Yes, it has successfully argued that the receipt of a profits interest is taxable on receipt (unless subject to restrictions that can result in the deferral of taxation). So what's the problem?

The problem is that, much like the dog chasing the car, the IRS quickly realized that it did not know what to do with what it had caught. Taxation upon receipt raises all sorts of questions in the partnership context. If a partner is taxed upon receipt, how is he or she

Most proposed legislation has suggested that a carried interest should not be taxable on receipt, but income thereafter received should be taxed as ordinary income.

taxed when the unrealized income is actually realized (after all, he or she has already been taxed)? Do the other partners get a deduction for the compensation income? Should the basis in partnership assets be increased by the value allocated to the partner (this can happen on a transfer of an interest)? Succumbing to the inevitable, the IRS issued a revenue procedure and reverted back to the liquidation fiction in order to avoid all of these complexities.

That leaves the alternative that has been in the news during the last year. Most proposed legislation has suggested that a carried interest should not be taxable on receipt, but income thereafter received should be taxed as ordinary income.

This sounds simple, but it is actually as complex. First, should all people receiving a carried interest be taxed at ordinary rates? If you and I buy an apartment building and I agree to do the leasing for an interest in the appreciation, should I be taxed at ordinary income tax rates? What if I put some money in, but not as much as you? What if we both put in the same amount of money but you loan the partnership the difference? Should that change the character of my income? Why should a sole proprietor who puts in money but also provides services be taxed at capital gains when he or she sells, but not partners? Fortunately, I do not have to answer these questions.

Future Outlook

What will the future bring? As I mentioned above, there have been various proposals. The last proposal was included in last year's alternative minimum tax patch, but it was eventually stripped out.

This issue will resurface again for two reasons. First, and most importantly, the provision is seen as a revenue raiser, and Congress is always looking for revenue raisers. Second, there is a perceived inequity, although the perception may die as the economy does. There should be no action this year, it being an election year. However, the fun and games will begin in 2009, mainly because the Bush tax cuts expire in 2010, and my money is on adoption of something similar to the last proposal, assuming the Democrats retain control of Congress. (There goes simplification.)

So, keep using this time-honored structure for now. It still provides excellent tax benefits to persons who provide services to partnerships, whether or not your partnership is a Blackstone or simply a partnership between you and me.

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NEWS ALERT | FSA Clarifies Disclosure Regime for Short Selling During Rights Issues

On 13 June 2008, the FSA announced that it was amending the Code of Market Conduct with effect from 20 June 2007 to require the disclosure of significant short positions in stocks admitted to trading on a prescribed market (which includes all the markets established under the rules of a UK recognised investment exchange, such as the London Stock Exchange). A position is a significant short position if it represents an economic interest of 0.25% of the issued share capital of a company.

This change has taken the market by surprise in two ways: first, the fact that the FSA should be proposing anything in this area; and second, that the proposal should have been brought in without any consultation, which gives firms very little time to amend their systems so as to comply. It is rare for the FSA to make changes without consultation with the market. The Financial Services and Market Act 2000 does allow the FSA to make changes to its rules without prior consultation, in circumstances where the FSA considers that the delay that would otherwise occur would be prejudicial to the interests of consumers. But the suspicion here is that it is not so much the interests of consumers that the FSA is concerned with, but rather the interests of those banks which are seeking to raise fresh capital by means of rights issues. It is perhaps no coincidence that the FSA announced the changes only a few days after the price of shares in HBOS fell below the price of its rights issue.

The FSA's press release indicates that the FSA views short selling as a legitimate technique, which assists liquidity and is not in itself abusive. This should give some comfort to firms that the FSA's move is not the first step in a general campaign to clamp down on short selling. But inevitably a move of this nature, without consultation, has left a number of questions open. The Financial Times of 17 June 2008 identified a number of such questions, and, later that day, the FSA published answers to what it termed "Frequently Asked Questions" ("FAQs") on the changes, in order to clarify the position. This list is not exhaustive, and may be updated in the future. The FAQs cover some, but not all, of the questions listed in the Financial Times. Among the points made are the following:

- the disclosure responsibility applies to all publicly listed companies in the UK, whether UK incorporated or not; companies with a primary listing elsewhere, and a secondary listing in the UK, are therefore covered, though the FSA envisages that the disclosure obligations will primarily relate to UK incorporated companies, given that the use of rights issues to raise capital is more common in the UK than elsewhere;
- the disclosure must be made by announcement to a Regulatory Information Service; FSA has provided a form for this purpose (available on the FSA website), though a different format may be used so long as the information required by the FSA form is provided;
- the calculation of the disclosable interest should be based on the percentage of the issued share capital as it stood before the rights issue;
- options should be included, even options that cannot be exercised during the rights issue period;
- the requirement to disclose applies to positions taken before the time the rights issue period commences, if they meet the 0.25% threshold once that period commences (though this seems hard to square with the amendment to the Code of market conduct, which requires the 0.25% position to be "reached or exceeded" during a rights issue period);
- there is no obligation to make further disclosures should the short position subsequently increase (though the FSA may consider the introduction of an incremental disclosure requirement if this appears to add value; and
- intra-day positions do not have to be disclosed; the key time for assessing whether disclosure is required is midnight on the day in question.

It remains to be seen whether the FSA's reputation for fair dealing with the industry will suffer lasting damage. To judge from the press release put out by the Alternative Investment Management Association, which mentioned its "disappointment" with the new provisions and its belief that the FSA has set an "awkward precedent", it would appear that the regulator may have some fence-mending to do. Rather ominously, the FSA press release refers to the fact that the FSA is "giving consideration" to taking other measures in this area, and that it is currently examining a number of options, including restricting the lending of stock in rights issues for the purposes of enabling short selling, and restricting short sellers from covering their positions by acquiring rights to the newly issued shares. One can only hope that the FSA will have learnt a lesson from the reaction the present proposal has engendered and allow the industry adequate time to respond to any further initiatives in this area.

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