KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

The Alternative Investment Fund Managers Directive Has Finally Arrived

Simon Firth

Partner

Corporate & Finance

London

Owen D. Watkins

Consultant

Corporate & Finance

London

After over eighteen months of wrangling, the EU's Alternative Investment Fund Managers Directive (the "Directive") was finally passed in November 2010. The Directive affects managers and promoters of alternative investment funds, including hedge, private equity and real estate funds, and its reach extends to managers and advisers based outside as well as inside the EU (respectively "EU managers" and "non-EU managers").

Timing

Although the Directive is expected to be "in force" from January 2011, Member States of the European Union have two years from that date to implement the Directive. Effectively, therefore, nothing will change until early 2013.

In the meantime, the European Commission ("Commission") will be producing so-called "Level 2" measures, which will flesh out the general principles set out in the Directive. These Level 2 measures will also be required to be implemented by early 2013, and are critical to how firms will be affected by the Directive. For instance, they will cover such matters as liquidity management and procedures, when leverage is considered to be employed on a substantial basis, and the criteria for assessing whether third-country standards of regulation and supervision have the same effect as those in the EU. The Commission has already asked the Committee of European Securities Regulators ("CESR") for technical advice on the preparation of the Level 2 measures, and is aiming to finalize them by early 2012, so that Member States will have a year in which to implement them.

In 2015, two years after the Directive has been implemented, the European Securities and Markets Authority ("ESMA") (the successor body to CESR from January 1, 2011) is required to advise the Commission on whether the marketing passport conferred by the Directive, which EU managers will have on implementation, should be extended to non-EU managers. If the advice is positive, the Commission must specify the date when this extension will occur within three months of ESMA's advice appearing.

Assuming that that advice is positive and the passport is extended to non-EU managers beginning in 2015, ESMA is required to issue further advice in 2018 as to whether national private placement regimes allowed for under the Directive should be terminated. If ESMA concludes that this should occur, the Commission has three months to specify the date after which private placement regimes will no longer be allowed. This could be later than 2018 so as to allow a transitional period for firms to adapt to the new arrangements.

IN THIS ISSUE

> *If the passport is made available to non-EU managers in 2015, a U.S. manager who wishes to obtain it will need to comply with all the provisions of the Directive.*

Exclusions

The Directive provides that if an EU manager has assets under management below certain thresholds (in general, €100 million or, for unleveraged funds with no redemption rights for five years (typically smaller private equity funds), €500 million), the Directive will not apply. In such cases, however, registration with the local regulator (along with disclosure of investment strategies and trading information) will still be necessary, and the Directive also allows the regulator to impose additional requirements.

U.S. managers, private placement, and the passport

As noted above, non-EU managers, such as U.S. alternative fund managers, will not be able to obtain passports until 2015. Until then, they will need to market their funds in reliance on the private placement regimes that operate in individual EU Member States.

From 2013, once the Directive is implemented by EU Member States, U.S. managers will be required to comply with certain "transparency" provisions of the Directive relating to the production by the fund of an annual report, disclosure requirements to investors, and periodic reporting to the local regulator covering such matters as the liquidity of the fund, risk management and leverage. There will also need to be information-sharing arrangements in place between the SEC and the local EU regulator and (assuming the fund is not in the United States) the supervisors of the fund and the local EU regulator. In addition, the United States and (if different) the country where the fund is located must not be on the FATF "blacklist" of states which give rise to money laundering and terrorist financing concerns. For a U.S. manager marketing a Cayman fund to investors in the U.K., all the requirements in the previous sentence are currently satisfied, so it will be up to the manager to ensure that the "transparency" provisions are satisfied also.

If the passport is made available to non-EU managers in 2015, a U.S. manager who wishes to obtain it will need to comply with all the provisions of the Directive (including those relating to remuneration restrictions, capital requirements, depositaries and leverage). It will also need to apply to an EU Member State — the manager's "Member State of reference" for the purposes of the Directive — and the regulator in that state will in effect become the U.S. manager's supervisor for compliance with the Directive. The U.S. manager will also need to appoint a legal representative in the "Member State of reference" to act as its contact point with the local regulator. In addition:

- there must be cooperation arrangements in place between the regulator in the "Member State of reference" and the SEC covering information sharing; and

- the country where the fund is located must not be on the FATF "blacklist" (for which see above); and

- the country where the fund is located must have signed an agreement with the "Member State of reference" and any other EU Member State where the fund is proposed to be marketed relating to the exchange of tax information and in compliance with OECD requirements. (The Cayman Islands currently has such an agreement with the U.K. and several other EU Member States, including France, Germany and Ireland.)

U.K. managers, private placement and the passport

For U.K. managers managing non-EU funds, such as Cayman funds, the marketing passport will also not be available until 2015. Until then, U.K. managers must continue to market their non-EU funds in the EU through national private placement regimes. The Directive requires that from 2013 the U.K. manager will have to comply with all the provisions of the Directive, apart from those relating to depositaries; there will need to be cooperation agreements between the regulator of the fund and the FSA; and the jurisdiction where the fund is located must not be on the FATF "blacklist" (for which see point 3 above).

Once the passport becomes available for non-EU funds, the U.K. manager will need to comply with the Directive in full (*i.e.*, the depositary requirements will now apply in respect of the fund), and the three bullets above will need to be satisfied.

Private equity

The Directive contains additional requirements relating to disclosure of acquisition or disposal of stakes of 10% or more in portfolio companies, disclosure when the fund takes control of a company (including its intentions with regard to the future business of the company and the likely repercussions on employment), and (perhaps most important) provisions designed to prevent "asset-stripping," under which certain distributions to shareholders are restricted for 24 months after the fund takes control of the company.

A key point to note is that, as with hedge funds, the Directive requires private equity funds to have an independent depositary. Although the types of entity that can act as a depositary is wider for private equity funds than for hedge funds, thus potentially giving more choice, this requirement is likely to add significant costs. This may lead some private equity general partners to try to keep their business outside the scope of the Directive: for instance, by keeping the level of the fund below the €500 million threshold, or by making all investments before the Directive has to be implemented by EU Member States (early 2013).

The capital requirements of the Directive are also likely to have a particular effect on those private equity firms which currently fall outside the scope of the Markets in Financial Instruments Directive ("MiFID") and thus outside the requirements of the Capital Adequacy Directive ("CAD").

Such firms have been allowed to operate in the U.K. with a minimum capital requirement of £5,000 (approximately €5,900). In contrast, the Directive requires a manager to hold minimum capital of €125,000, plus an additional 0.02% of the amount by which the funds under management exceed €250 million, capped at €10 million. In addition, if they do not have insurance, managers are required to hold extra capital to cover potential liability for professional negligence.

When the "passport" becomes available, allowing EU and non-EU managers to market non-EU funds throughout the EU, jurisdictions that would satisfy the criteria set out in the Directive to allow the fund to qualify for the "passport" will have an advantage over those that do not.

Marketing

The Directive defines "marketing" as offering of funds at the initiative of or on behalf of the manager. That means that if an investor takes the initiative by approaching the fund manager, the fund manager will not be marketing his funds for the purposes of the Directive. It follows from that that a U.S. manager will not be brought within the scope of the Directive simply because he accepts investments from an EU pension fund manager; the manager would need actively to market the fund to those investors for that to occur.

The U.S. manager is likely to have a website that allows interested parties to access details of the funds. Although the manager will in one sense have "taken the initiative" by making the material on the website available, we do not think this would not be "marketing" for the purposes of the Directive without some further act by the manager (for example, a separate e-mail directed at potential customers drawing attention to the existence of the site). There is consequently no need for U.S. managers who do not wish to be subject to the Directive to erect a "firewall" or similar means to prevent their website from being accessed by EU investors.

Delegation

The Directive does not prevent a fund manager from delegating its functions to third parties, although it does impose some restrictions. In particular, the portfolio management and risk management function may be delegated only to entities that are authorized or registered to carry out such functions and subject to supervision (and where delegation is to an entity outside the EU, there must be cooperation between the third-country supervisors and the manager's EU regulator), and cannot be delegated to the depositary or the depositary's delegate. The manager remains liable to the fund and investors in the fund for any acts of the delegate.

A depositary may also delegate the custody of assets (and the related record-keeping) to third parties, provided that it does not delegate to avoid the requirements of the Directive, it can demonstrate an objective reason for the delegation, it exercises all due skill, care and diligence in the choice of delegate, and it ensures that the delegate fulfils certain conditions (such as having appropriate structures and expertise and being subject to effective prudential regulation and supervision). Although in general the depositary remains liable for loss of assets held in custody, even if the assets are held by a third-party delegate, it is possible for the depositary to transfer liability for any loss of assets held by a third party to the third party, provided that this is done by written contract and the fund or manager is able to make a claim against the third party for any loss of custody assets.

Disclosure

Most of the information required by the Directive will already have been provided in a well-drafted offering memorandum. That said, the Directive also requires disclosures that are unlikely to be made currently, such as:

- valuation procedure and methods used for valuing hard-to-value assets;
- the fund's liquidity risk management;
- the type of investors who have the right to receive (or do receive) preferential treatment, and what that preferential treatment consists of;
- what steps the manager is taking to cover potential professional liability risks; and
- how and when the manager will disclose various liquidity and leverage information required by the Directive (such as the percentage of assets of the fund that are subject to special arrangements because of their illiquidity and the total amount of leverage employed by the fund).

The fund manager will also be required to make certain disclosures to its regulator. Again, much of this will already have been required under current arrangements, although some material is likely to be new, such as details of the fund's illiquid investments and the results of the stress testing of the fund's portfolio.
Managers of private equity funds are required to make additional disclosures: see point 5 above.

Consequences for onshore EU and offshore funds

Managers in the EU managing EU funds will have the "passport" to market those funds in the EU from early 2013. No such passport will be introduced for non-EU funds until early 2015 at the earliest. So onshore EU funds will have a significant marketing advantage over offshore funds for at least two years. We can expect to see various EU jurisdictions seek to make the case for onshore funds: indeed, the U.K. government has recently announced their plans to create such funds in the U.K., which suggests that they are keen to compete for any new business with the traditional domiciles of Luxembourg and Ireland and the newer contenders such as Malta, Cyprus and Gibraltar.

When the "passport" becomes available, allowing EU and non-EU managers to market non-EU funds throughout the EU, jurisdictions that would satisfy the criteria set out in the Directive to allow the fund to qualify for the "passport" will have an advantage over those that do not. But to what extent this will result in a change in the domicile of funds from one overseas jurisdiction to another is difficult to say. The main offshore jurisdictions (Cayman, Bermuda, Channel Islands) appear confident that they are well placed to benefit from the introduction of the Directive. As noted above, any threat to the established offshore jurisdictions may come more from onshore than from their traditional offshore rivals.

Simon Firth
sfirth@kayescholer.com

Owen D. Watkins
owatkins@kayescholer.com

IRS Publishes FATCA Guidance

Willys H. Schneider

Partner
Tax
New York

David A. Sausen

Associate
Tax
New York

Although FATCA does not come into effect until 2013, it has already been the subject of rather intense attention and concern on the part of foreign entities — including hedge funds and others — that must determine how to comply so as to avoid a potential new U.S. withholding tax.

The Hiring Incentives to Restore Employment ("HIRE") Act, enacted earlier this year, includes a provision known as the Foreign Account Tax Compliance Act ("FATCA"), which is designed to police offshore investments, accounts and trust interests held by certain U.S. persons. Although FATCA does not come into effect until 2013, it has already been the subject of rather intense attention and concern on the part of foreign entities — including hedge funds and others — that must determine how to comply so as to avoid a potential new U.S. withholding tax. In response thereto, the U.S. Internal Revenue Service (the "IRS") recently issued a Notice (described below) containing some preliminary guidance in respect of the provisions.

Background

Under FATCA, "foreign financial institutions" ("FFIs") that do not certify that they have no U.S. account holders are required to enter into an agreement (an "FFI Agreement") with the U.S. Treasury to obtain and report identifying and other account-related information with respect to U.S. holders. Failure to comply will result in FFIs being subject to a 30% U.S. withholding tax on U.S.-source interest, dividends, rents, salaries and similar ("fixed and determinable annual or periodical") payments, as well as on gross proceeds from the sale or other disposition of property that can produce U.S.-source interest or dividends (all of such payments being referred to as "withholdable payments"). Income treated as effectively connected with the conduct by the foreign person of a U.S. trade or business ("ECI") and already subject to U.S. income tax would, however, not be subject to this withholding tax.

If the FFI is itself the beneficial owner of a payment with respect to which tax has been withheld, and is entitled to a reduced rate of tax on the payment under a tax treaty, the FFI can claim a credit or refund of over-withheld tax, but no interest is allowed with respect thereto.

The FFI Agreement also would require FFIs themselves to withhold on payments attributable to "withholdable payments" made to an account holder who does not itself furnish required information, or who is itself an FFI not in compliance with the new provisions, unless an election is made to subject such amounts to the withholding tax described above, without reduction pursuant to any treaty provision.

FFIs include not only foreign banks, but also other foreign entities engaged in investing, or trading in securities, *e.g.*, foreign hedge funds. In addition, other non-financial, foreign entities (so-called "non-financial foreign entity" or "NFFEs") are subject to the same withholding tax on certain U.S.-source payments if they do not report information on U.S. owners, unless they can certify that they have no "substantial" (generally over 10%) U.S. owner, with certain exceptions for, *inter alia*, publicly traded corporations, foreign governments or agencies or instrumentalities thereof, and foreign central banks.

> *Although FATCA generally is effective for payments made after December 31, 2012, "obligations" outstanding on March 18, 2012 (i.e., two years after enactment) are generally not subject to the FATCA withholding regime.*

As noted above, the new rules apply to payments made after December 31, 2012. There is, however, a "grandfathering" rule in respect of (i) payments on any obligation outstanding on the date that is two years after the date of enactment or (ii) the gross proceeds from any disposition of such an obligation. Such payments or proceeds are not subject to the new withholding tax.

IRS Notice 2010-60

On August 27, 2010, the IRS issued Notice 2010-60 (the "Notice"), which provides preliminary guidance regarding certain "priority issues" involving the implementation of FATCA, including (1) the scope of obligations exempt from withholding, (2) the definition of an FFI, (3) the scope of the required collection of information and identification of persons by FFIs and U.S. financial institutions and (4) the specific information that FFIs must report to the IRS pursuant to an FFI Agreement with respect to their U.S. accounts. The IRS intends that most of this guidance ultimately will be formalized in regulations to be issued at a later date. A summary of key aspects of the Notice follows.

Grandfathered Obligations

Although FATCA generally is effective for payments made after December 31, 2012, "obligations" outstanding on March 18, 2012 (*i.e.*, two years after enactment) are generally not subject to the FATCA withholding regime. The Notice provides that, for this purpose, the term "obligations" generally does not include stock or other equity interests or agreements that lack a definitive expiration or term (the latter including deposit accounts or brokerage agreements). Any material modification of an obligation will, however, result in the obligation being treated as newly issued for purposes of FATCA, thus potentially taking it out of the "grandfathering" protection.

Definition of FFI

FATCA requires withholding of 30% from any "withholdable payment" to an FFI that does not meet certain requirements. To meet such requirements, an FFI generally must enter into an FFI Agreement with the IRS, pursuant to which the FFI must agree to undertake certain due diligence, reporting and withholding responsibilities. An NFFE is excluded from the definition of an FFI and is subject to separate documentation and reporting requirements, unless an exception applies.

An FFI generally is defined as a foreign entity that (1) accepts deposits in the ordinary course of a banking or similar business, such as a bank or credit union, (2) holds financial assets for the accounts of others as a substantial portion of its business, such as a broker-dealer or custodial bank, or (3) is engaged primarily in the business of investing, reinvesting or trading, directly or indirectly, in securities, partnership interests or commodities, such as a mutual fund, hedge fund, private equity fund or venture capital fund. The Notice provides that the concept of "business" for this purpose is highly factual and generally will be broader than the concept of "trade or business" as used elsewhere for U.S. tax purposes (*e.g.*, in determining whether a foreign entity is engaged in a U.S. trade or business and therefore subject to U.S. net income taxation). As such, isolated transactions that might not in general rise to the level of a trade or business may cause an entity to be treated as an FFI for purposes of FATCA.

Entities Excluded from the Definition of FFI. The Notice states that future IRS guidance will provide that the following types of foreign entities engaged primarily in the business of investing, reinvestment or trading, directly or indirectly, in securities will not be treated as FFIs and, therefore, will not be subject to the FATCA withholding regime: (1) holding companies for a group of subsidiaries that primarily engage in a trade or business other than that of a financial institution;[1] (2) "start-up" companies (*i.e.*, companies not yet operating a business) for the first 24 months following their organization; (3) non-financial entities in the process of liqui-

[1] This class of excepted entities will not, however, include investment funds, such as private equity funds, venture capital funds, leveraged buyout funds, or any investment vehicle whose purpose is to acquire, or fund the start up of, companies and hold them for investment purposes for a limited period of time.

dating or reorganizing; and (4) entities engaging in financing and hedging transactions solely with, or for, certain related entities (assuming such members are not themselves FFIs).

Future IRS guidance also will provide that entities whose business consists solely of issuing insurance or reinsurance contracts will not be treated as FFIs for purposes of FATCA.[2] In addition, certain FFIs with only a small number of direct or indirect account holders, all of whom are individuals, will be exempt from the FATCA withholding regime if such FFIs comply with certain IRS documentation requirements. Finally, entities organized in U.S. territories, although generally treated as "foreign" for U.S. tax purposes, will be treated as domestic for purposes of FATCA.

Retirement Plans. FATCA provides the IRS with discretion to exclude certain classes of financial institutions from the FATCA withholding regime to the extent the IRS determines that such entities pose a low risk of tax evasion. Pursuant to the Notice, the IRS intends to exercise this discretion by providing that a foreign retirement plan is exempt from the withholding regime, provided that the plan (1) qualifies as a retirement plan under the relevant foreign law, (2) is sponsored by a foreign employer, and (3) does not allow U.S. participants or beneficiaries (other than employees that worked for the foreign employer in the country in which such plan is established during the period in which benefits accrued). This should be a welcome development for foreign pension plans.

Treatment of U.S. Branches and CFCs. Under FATCA, a payment to an FFI that is considered ECI to such FFI is excluded from the FATCA withholding regime. This ECI exclusion, however, does not cover all payments that may be made to an FFI's U.S. branch, such as payments received on behalf of the FFI's account holders rather than for its own account. In the Notice, the IRS has affirmed its intention not to exempt an FFI from FATCA even if the FFI receives withholdable payments solely through its U.S. branch. However, where a U.S. branch of an FFI receives a withholdable payment as an intermediary, the IRS may consider permitting the U.S. branch to avoid withholding by complying with less stringent documentation requirements.

A controlled foreign corporation (a "CFC") (*i.e.*, a foreign corporation more than 50% of the vote or value of which is held by certain U.S. persons) that qualifies as a financial institution is considered an FFI and subject to FATCA. Despite industry opposition to this rule, the IRS has affirmed in the Notice its intention not to exempt CFCs from the FATCA rules.

A controlled foreign corporation (a "CFC") (i.e., a foreign corporation more than 50% of the vote or value of which is held by certain U.S. persons) that qualifies as a financial institution is considered an FFI and subject to FATCA. Despite industry opposition to this rule, the IRS has affirmed in the Notice its intention not to exempt CFCs from the FATCA rules.

Scope of Collection of Information and Identification of Persons by FFIs

FATCA generally requires FFIs to enter into an FFI Agreement with the IRS in order to avoid the 30% withholding tax noted above. An FFI Agreement generally provides that the participating FFI (1) will obtain such information regarding each holder of each account maintained by the FFI as is necessary to determine which (if any) of such accounts are "U.S. accounts,"[3] (2) comply with IRS-specified due diligence procedures and (3) report to the IRS certain information with respect to each U.S. account. In addition, a participating FFI must agree to withhold tax on certain payments made to non-participating FFIs and certain "recalcitrant" account holders (including account holders that

[2] The Notice provides, however, that life insurance contracts (other than term life insurance contracts without cash value) and annuity contracts generally include an investment component and, therefore, entities that issue such contracts likely will continue to be treated as financial institutions for purposes of FATCA.

[3] "U.S. accounts" are financial accounts held by one or more specified U.S. persons or U.S.-owned foreign entities.

Although there are still two full years before the FATCA provisions become effective, once they come into play they will have a significant impact on foreign banks, funds and other foreign persons (as well as on U.S. payors of U.S.-source amounts to such foreign persons).

fail to comply with reasonable requests for information).

FATCA also requires a U.S. financial institution or other withholding agent, subject to certain exceptions, (1) to withhold tax on certain withholdable payments made to an NFFE and (2) to report certain information regarding the "substantial U.S. owners" (generally, more than 10% owners) of the NFFE. NFFEs excepted from these rules include (A) publicly traded corporations and certain related entities, (B) entities organized under the laws of a U.S. territory and wholly owned by bona fide residents thereof, (C) foreign governments, including political subdivisions or wholly owned agencies or instrumentalities thereof, (D) certain international organizations or any wholly owned agencies or instrumentalities thereof and (E) foreign central banks of issue.

The Notice provides specific procedures to be applied by participating FFIs and U.S. financial institutions to make the determinations required to comply with the provisions of FATCA. Most notably, the Notice provides certain presumptions that may be applied by an FFI or a U.S. financial institution in determining the status of an account, based on information gathered for other purposes (including other U.S. tax purposes). In addition, the Notice provides that an FFI (but not a U.S. financial institution) can treat certain depository accounts with average balances of less than $50,000 as other than a U.S. account without further inquiry.

Information Required to be Reported Pursuant to an FFI Agreement

Under an FFI Agreement, FFIs are required annually to provide the IRS certain information with respect to their U.S. accounts, including the name, address and taxpayer identification number of each U.S. account holder, account balance or value, and the gross receipts and gross withdrawals or payments from the account. The Notice states that the IRS is considering how best to implement these reporting requirements.

Conclusion

Although there are still two full years before the FATCA provisions become effective, once they come into play they will have a significant impact on foreign banks, funds and other foreign persons (as well as on U.S. payors of U.S.-source amounts to such foreign persons). Foreign entities subject to these new rules are well advised to plan ahead by putting mechanisms into place that will enable them to comply with the various due diligence and reporting requirements so as to avoid an unnecessary U.S. withholding tax burden.

Willys H. Schneider
wschneider@kayescholer.com

David A. Sausen
dsausen@kayescholer.com

Key Structural Elements of Private Equity Funds

Timothy A. Spangler
Partner
Corporate & Finance
Chair
Investment Funds Group
New York
and Los Angeles

Many of the key structural elements of private equity funds ("PE Funds") result, directly or indirectly, from the use of partnerships as the principal fund vehicles. Although there is no legal requirement to have a written partnership agreement, they are common in PE Funds in order to provide certainty with regards to each partner's rights and liabilities.

A partnership agreement is a contract and will be interpreted in accordance with the principles of contract law. Partners should review their partnership agreement regularly to ensure that the document still accurately and fully reflects the desires of the partners.

Partners should review their partnership agreement regularly to ensure that the document still accurately and fully reflects the desires of the partners.

Capital contributions

When investors agree to participate in a PE Fund, they join the partnership established by a private equity sponsor firm (the "PE Sponsor") as a limited partner who agrees to make capital contributions over a period of time to acquire selected investments and to pay agreed expenses of the PE Funds. An affiliate of the PE Sponsor will serve as a general partner to the PE Fund.

Limited partners typically contribute their capital to the fund over time, upon receipt from the general partner of a draw-down notice. A limited partner would usually have ten days to provide the fund with the monies requested or be subject to potentially quite serious consequences. Exceptions would be made only for those limited partners who might be excused from making a particular investment because of investment restrictions pre-agreed with the general partner.

The capital contributions provision of the partnership agreement will be of significant importance, since it deals with the liability of each of them to make capital contributions and/or loans to the partnership. There are a number of different options, for example:

(a) an initial capital contribution and no further contributions without the unanimous agreement of all the partners.
(b) an initial capital contribution and a number of staged contributions thereafter up to an overall cap. There is the further credit risk here that the follow-up contributions may not be made, exposing the partnership to a potential shortfall; and
(c) a combination of the above together with a general requirement for the partners to input capital as and when required to meet any liability of the partnership or in order to carry out the business plan.

If there are any additional capital contributions following the initial contribution there would, of course, be a greater concern for each of the partners to ensure that failure to contribute gave rise to significant "penalties."

The general partner traditionally invests a certain amount of money alongside the limited partners, in order to ensure the interests of all partners are adequately aligned. Absent a significant investment in the fund by the general partner, the concern of many prospective investors will be that the operation of the carried interest will be to present the general partner with a "heads I win, tails you lose" scenario.

The commitment of the general partner can occur directly through the fund vehicle itself, which would ensure that it participates *pari passu* with every investment made by the limited partners, or the general partner may participate *ad hoc* in fund investments of its choosing on a case by case basis.

Management of the partnership

The management clause typically provides that the limited partners are to play no part in the management of the business. It would usually provide for the general partner to act on the partnership's behalf but only to the extent of appointing and controlling the fund manager.

Generally, certain actions and requirements may require the majority or unanimous consent of the limited partners, including:

(a) an change to the appointment of the investment manager;
(b) the sale of any of the partnership assets before the termination date;
(c) additional capital contributions; and
(d) changes to the business plan.

Any further action by a concerned limited partner will need to be closely analyzed to ensure it does not rise to such a level as to threaten his limited liability.

Usually the general partner exempts itself for liability save for fraud, negligence, or wilful default. However, the partners will often wish to reserve the right to dismiss the general partner if the general partner acts in breach of its obligations. Such provision may be either with cause or without cause. Whether or not such provisions are ever actually invoked, including a clear mechanism for removing a general partner can serve as an effective tool for overcoming the governance challenge.

Default

Any default by the limited partners will typically be a breach of the limited partnership agreement. However, failing to make the required capital contributions is a particular default that simple common law remedies may not be sufficient to cover. Accordingly, there are a number of alternative possibilities that could be considered:

(a) the defaulting partner could be compelled to transfer his partnership interest at a discount. This may not be a sufficient deterrent to breach on a downturn;
(b) the non-defaulting partners could become deemed entitled to a disproportionate amount of the capital account (and therefore the partnership profits);
(c) the non-defaulting partners could be entitled to find another partner and to raise funds on any terms they saw fit.
(d) the non-defaulting partners could be entitled to put more money in on a preferred basis (*e.g.*, get paid out in priority or get a preferred return); and
(e) the defaulting partner could made to forfeit their right to vote on any issue.

Often potential disputes between a limited partner and a general partner will involve threats from both sides that invoke these default provisions. For limited partners concerned about the risk to their limited liability should they become involved in the management of the partnership, a belief that the general partner, or the affiliated fund manager, has breached a duty owed to the partners may be actioned by an indication that one or more limited partners will not comply with any further drawdown requests until the alleged breach is resolved. Negotiations that follow between the parties will seek to avoid the need to invoke the default provisions by resolving the underlying issues.

Investment Period

The investment period of a PE Fund will often last between 4–7 years. At the end of this period, any undrawn capital commitments of a limited partner will fall away and not be subject to draw-downs by the general partners, except to pay for expenses or, in limited circumstances, to fund follow-on investments in companies already in the fund's portfolio.

Once an investment has been sold by the PE Fund, those proceeds are generally refunded promptly back to the limited partners. Exceptions can be made for certain investments that are held for less than 12 or 18 months, and general partners can be permitted to redraw and reinvest such amounts.

Timothy A. Spangler
tspangler@kayescholer.com

Fallout From Dodd-Frank: Foreign Banks Sponsoring ABCP Conduits May Need to Register as Investment Advisers

Eric P. Marcus
Partner
Corporate & Finance
New York

One of the many federal laws affected by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") signed by President Obama on July 21, 2010, is the Investment Advisers Act of 1940 (the "IAA"). Thus far, the amendments to the IAA have not received much attention from the securitization industry, but the amendments do impose new registration and compliance requirements on certain participants in securitization transactions. In particular, foreign banks that sponsor ABCP conduits may be surprised to learn that they will become subject to these new requirements.

Thus far, the amendments to the IAA have not received much attention from the securitization industry, but the amendments do impose new registration and compliance requirements on certain participants in securitization transactions.

The IAA defines an investment adviser as a person who, for compensation, advises others as to the advisability of investing in, purchasing or selling securities. For purposes of the IAA, the term "securities" is very broadly defined and includes any note or evidence of indebtedness. Accordingly, assets purchased by an ABCP conduit would constitute "securities."

The sponsor of an ABCP conduit typically acts as administrative agent for the conduit, and selects and structures the transactions that are funded by the conduit. It appears, therefore, that the administrative agent would meet the requirements of the statutory definition of investment adviser, although there may be a question as to the compensation requirement.

Conduits have differing compensation arrangements with their agents, and there may not exist a specific fee agreement for administrative agent services. However, the bank sponsor typically receives, in one capacity or another, the bulk of the cash flow distributed by the conduit (after payment of debt service and third-party expenses such as placement agent and depository fees, audit fees, taxes, *etc.*). This cash flow may be paid out to the sponsor in its capacity as liquidity provider or as credit enhancer, or there may be a waterfall that provides that excess cash flow that is not used for any other purpose is paid to the sponsor. In view of these types of arrangements, it would seem to be difficult to argue that the administrative agent is not being compensated for its activities in selecting and structuring the conduit's assets, even if there is no express fee agreement between the conduit and the administrative agent.

The IAA requires investment advisers to register with the SEC, adopt certain compliance policies, maintain certain books and records, make public filings with the SEC, and submit to SEC examination. Currently, virtually all bank sponsors of ABCP conduits are exempt from registration under the IAA on the basis of one of two statutory exemptions. The first exemption (the "U.S. Bank Exemption") covers banks organized under the laws of the United States, member banks of the Federal Reserve System, banks or trust companies doing business under the laws of a state or the United States a substan-

The Private Adviser Exemption is eliminated by Section 403 of the Dodd-Frank Act, effective July 21, 2011. U.S. branches of foreign banks, which have heretofore relied on the Private Adviser Exemption, and which are not eligible for the U.S. Bank Exemption, will no longer be exempt after July 21, 2011.

tial portion of which consists of receiving deposits or exercising fiduciary powers, and bank holding companies (as defined in the Bank Holding Company Act).

The second exemption (the "Private Adviser Exemption") applies to an adviser with fewer than 15 clients in the last 12 months that does not hold itself out to the public as an investment adviser and does not advise any registered investment company. The Private Adviser Exemption is eliminated by Section 403 of the Dodd-Frank Act, effective July 21, 2011. U.S. branches of foreign banks, which have heretofore relied on the Private Adviser Exemption, and which are not eligible for the U.S. Bank Exemption, will no longer be exempt after July 21, 2011. On the other hand, U.S. banks that sponsor conduits will continue to be exempt pursuant to the U.S. Bank Exemption.

U.S. branches of foreign banks are already subject to extensive regulation at both the state and federal levels. In fact, other provisions of the Dodd-Frank Act (*e.g.*, the definition of "banking entity" in the Volcker Rule, Section 619 of the Dodd-Frank Act) and many other U.S. banking laws (such as Section 8(a) of the International Banking Act) treat U.S. banks and U.S. branches of foreign banks similarly. There is no apparent policy reason for treating U.S. banks and U.S. branches of foreign banks differently under the IAA.

Although many provisions of the Dodd-Frank Act are subject to implementation through regulatory rulemaking, the elimination of the Private Adviser Exemption is not one of these. This leaves U.S. branches of foreign banks with two options: they can either register with the SEC as investment advisers, or seek a waiver pursuant to an SEC no-action letter or SEC interpretation.

Registration is a relatively straightforward process, and the ongoing compliance requirements under the IAA should not be unduly burdensome for a large bank that already has numerous other compliance programs in place. However, foreign banks should make a decision well in advance of the July 21, 2011, registration deadline as to how they wish to proceed, in order to ensure that compliance is implemented on time, or if they wish to seek a waiver pursuant to a no-action letter, that sufficient time is allowed to prepare a no-action letter request and to make contingent plans to register in the event the request is not granted.

Eric P. Marcus
emarcus@kayescholer.com

Chicago Office
+1.312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1.310.788.1000

New York Office
+1.212.836.8000

Palo Alto Office
+1.650.319.4500

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1.202.682.3500

West Palm Beach Office
+1.561.802.3230