KAYE SCHOLER LLP

INVESTMENT FUNDS NEWSLETTER

Second Chances: Opportunities in the Secondary Fund Market

The recent liquidity crunch and resulting financial market turmoil have driven many institutional investors to question their continued exposure to private investment funds, such as private equity funds and hedge funds. Some have sought to rebalance their portfolios, as the drop in the value of publicly traded assets caused their portfolios to be excessively exposed to alternative investments, regardless of their view on the fundamental strengths of their fund investments. Others soured on these asset classes, although many investors remain keen on the near-term and medium-term opportunities.

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Initially, some investors sought to sell their limited partnership ("LP") interests in secondary sales. A few were successful; many were not. A fundamental supply-and-demand imbalance appeared, as willing buyers were far outnumbered by potential sellers.

Importantly, many of the interests on offer have been in recently launched funds with large amounts of undrawn commitments outstanding. An LP interest that is only 10% to 20% invested is probably better seen as a "deferred primary" rather than a "true secondary," since this is primarily a bet on future unmade investments.

Given the difference in price perception, potential sellers face a stark choice. Some investors may continue to seek to sell their LP interests in the secondary market, but at a lower price. Others may decide not to re-enter the secondary market because they believe that using other methods to reduce their exposure to the asset class will be more effective. Further, selling an LP interest at too low a price raises a concern over "embarrassment risk," *i.e.*, when the markets (we hope) recover in the near future, what was sold now at a fraction of its true value may in time generate an oversized return for the buyer.

Rather than re-entering the secondary market at a reduced price, three methods to reduce LP commitments that are often considered include:

Negotiating with general partners ("GPs") to reduce the size of the fund

This proportionally reduces each LP's commitment. Notwithstanding the adverse financial effect on the GP, some GPs have been open to discussions with LPs about reducing the size of the fund. GPs may be amenable to this measure for several reasons. First, some GPs are concerned that in the current economic environment, it is difficult to see with clarity how they will invest a big fund and produce the returns that the LP community expects. Second, some GPs want to stay in good standing with the LP community, so that someday, when the GPs are fundraising again, the LP community will view them as having been cooperative in a difficult time and situation.

Negotiating with GPs to limit or freeze capital calls in the short- to medium-term

Some GPs and LPs view the current market conditions (for both publicly traded securities and alternative investments) to be temporary. Rather than reducing the fund size and LP commitments accordingly, GPs may prefer to agree to limit or freeze capital calls over the short- or medium-term (*e.g.*, 12, 24, 36 months) so as

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not to strain the financial resources of their LPs. This approach will allow time for the LPs to obtain more investable assets, and for the public market to recover and rebalance the LP portfolios to some degree. This approach is also consistent with the view of some GPs that finding quality assets in significant quantity in this financial environment will be difficult. This may be offered as a compromise to an LP's request to reduce the size of the fund. It should be noted that for some larger LPs with more influence over GPs, this type of agreement may be reached informally and in the context of how the LP will react to future fundraising efforts by the GP if the LP's appetite for capital calls in the short- and-medium terms is not accommodated.

Informally organizing within the LP community a bulletin board system of matching buyers and sellers

Although a formal secondary market for LP interests is often discussed, an active, liquid market has not developed. Bid-ask spreads in the current "over the counter" market are larger than would be the case if buyers and sellers could access an organized market and if the flow of pricing information were more robust. A broker community is developing to support these secondary sales, but few secondary sales actually occur, for various reasons that afflict many young and illiquid markets.

For a more formal market to become an effective platform for increased liquidity in secondary LP commitments, significant players in the LP community will need to come to implicit or explicit agreement on fundamental trading methods and standardization of the traded product. Enterprising intermediaries — including investment banks and brokerage firms — continue to seek new and innovative ways to take advantage of this opportunity.

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Coping with Distressed Portfolio Companies: the Potential Litigation Aftermath for Sponsors

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Businesses fail for many reasons, including those outside of management's control, and the "scorched earth" litigation tactics favored by unsecured creditors are not a cure-all for those failures.

One distinguishing characteristic of the current recession is the number of private equity firms forced to address financially troubled portfolio companies. Sponsors bought companies through leveraged buyouts that left substantial acquisition debt on the companies' books. Some of the same companies later took on more debt to pay early returns to their sponsors through dividend recapitalizations. As the economy worsened, many of these companies found themselves carrying more debt than they can support at lower revenues, which lead to a rash of bankruptcies and out-of-court restructurings. And, when portfolio companies fail, there is a growing sentiment amongst some creditors that the sponsors should be held responsible. A prime example is the Chapter 11 just filed by Simmons Bedding Co. Ownership of the company has changed hands six times in 20 years, and in each instance, as the price of the company rose, successive buyout firms placed more and more acquisition debt on the company to finance their purchase. Reports are that the company's debt rose from $160 million less than 20 years ago to its current $1.3 billion, and that along the way, private equity firms extracted $750 million in profits, in several instances through dividend recaps. Now that Simmons has fallen on hard times, hungry creditors are circling, and some pundits are suggesting that the latest private equity owner, which bought the business in 2003, may be legally accountable for leaving the company in such a vulnerable condition.

Experts predict that half of all portfolio companies will default on their debt obligations in the next three years. In fact, the data reflects that over the next few years, the volume of leveraged loans maturing doubles or triples each year, with $430 billion in leveraged loans maturing from 2012 to 2014. Few companies will be in a position to repay these loans on time, nor does it seem likely that the capital markets will recover far enough and fast enough to refinance the bulk of these loans. As a result, it appears that the worst still lies ahead and the current wave of portfolio company restructurings may not abate for another three to five years.

Most portfolio company restructurings will require a conversion of debt to equity that wipes out the sponsor's equity stake. The buyout firms seem to be adapting to this potential outcome; however, it is still a surprise to many that their exposure from a failed buyout could, through litigation, far exceed their original investment. The additional leverage means that when these portfolio companies are restructured, there may be no unencumbered assets, which may prompt unsecured creditors to consider other means of recovery, such as suing "deep pocket" sponsors for causing or substantially contributing to the portfolio company's demise.

Businesses fail for many reasons, including those outside of management's control, and the "scorched earth" litigation tactics favored by unsecured creditors are not a cure-all for those failures. Nevertheless, sponsors are increasingly the targets of disruptive litigation filed or threatened by unsecured creditors or bankruptcy trustees. The array of claims conceived by these litigants can seem limitless; here, we consider three of particular interest to sponsors:

- that the failed buyout was a fraudulent transfer and the sponsor should be liable as the party for whose benefit the transfer was made (especially in leveraged transactions with an "opco/propco" structure);
- that the sponsor should disgorge distributions received from a dividend recapitalization that allegedly rendered the company insolvent; and
- that the sponsor is liable for damages under a "deepening insolvency" theory that it artificially prolonged the company's life, to the detriment of creditors.[1]

Fraudulent LBOs

When a company acquired through a leveraged buyout subsequently fails, often for reasons unrelated to the ownership change, its unsecured creditors may argue, years after the fact, that they were harmed because the company's assets were encumbered by liens for which it received nothing in exchange. These creditors contend, with the benefit of hindsight, that the buyout left the company in a weakened state with few or no unencumbered assets for them to look to when the business failed. Most of these same creditors did not insist on collateral at the time and, in fact, benefited by continuing to do business with the company and its new owners. However, in litigation, they paint the sponsors as ruthless predators who reap quick returns by descending on healthy companies, wringing out the equity and selling without adding value.

Creditors looking to manufacture a return will consider recasting a buyout as a fraudulent transfer. There was a rash of these lawsuits following the junk bond market's collapse in the 1990s, mostly brought by failed companies against the lenders who provided the leveraged loans. Now creditors are dusting off the same theories and trying to expand them to sponsors.

There are two types of fraudulent transfers: those made with "actual intent to hinder, delay or defraud creditors," and "constructive" fraudulent transfers. Actual intent claims are rarely successful, in part because a sponsor can mitigate much of its risk by obtaining a solvency opinion from a reputable advisor firm. Also, to the extent that the buyout price is within a market range, the sponsor's equity contribution arguably provides the measure of solvency.

Constructive fraudulent transfers are transfers for less than "reasonably equivalent value" that render a company insolvent or close to it. The courts tend to collapse multiple stages of these transactions and conclude that the target was a mere "conduit" for the loan proceeds, which went to the former owners, and, thus did not receive adequate value for the loan. The inquiry then becomes whether the company was rendered insolvent or close to it. This depends on factors such as how much debt was incurred, the time between the transaction and insolvency, and whether intervening factors caused the target's insolvency. Once again, if the price is within a market range, the sponsor's equity contribution is the appropriate measure of solvency. As adeptly summarized by one influential court, "[b]usinesses fail for all sorts of reasons, and the fraudulent conveyance laws are not a panacea for such failures."[2]

Once a transfer is avoided, its value can be recovered from the initial recipient (the sellers), the entity for whose benefit the transfer was made (the sponsor), and some subsequent transferees. Creditors asserting these claims against sponsors argue that the buyout was for the sponsor's benefit as the sponsor provided only a fraction of the purchase price required to acquire the target and assumed no liability for the acquisition debt left on the target's books.[3]

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[1] Other "real world" examples include: (a) that the sponsor breached its fiduciary duties, or engaged in self-dealing, or aided and abetted officers' or directors' breach of their fiduciary obligations; (b) all manner of business torts (*e.g.*, tortious interference, unjust enrichment, corporate waste); (c) fraud or civil conspiracy; and (d) indirect claims against the sponsor, such as claims that the directors appointed by the sponsor to the board of the company breached their fiduciary duties or approved illegal dividends, which claims may ultimately be the sponsor's responsibility (if not covered by insurance) under the sponsor's indemnification in favor of its representatives.

[2] *Moody v. Security Pacific Business Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992) (rejecting claims that leveraged buyout included fraudulent transfers where company did not fail for 18 months after the transaction and the failure was the result of price-slashing and inventory-dumping by one of its competitors).

[3] One factor that may add to the number of claims asserted against sponsors is the fact that, in some jurisdictions, former shareholders may have a complete defense to a fraudulent transfer claim under Section 548 of the Bankruptcy Code. Those courts have determined that payments to selling shareholders, if by wire transfer, are immune as "settlement payments" made by a "financial institution" under Section 546(e) of the Bankruptcy Code. *Compare In re Elrod Holdings Corp.*, 394 B.R. 760, 763 (Bankr. D. Del. 2008) (payments to sellers for privately-held securities are "settlement payments" protected by § 546(e)) *with In re Norstan Apparel Shops, Inc.*, 367 B.R. 68 (Bankr. E.D.N.Y. 2007) (transfers are not "settlement payments" if the securities were not publicly held).

OpCo/PropCo

Creditors are particularly skeptical of buyouts with an "opco/propco" structure, popular where the target holds real estate assets in multiple locations such as large retailers, hotel chains, nursing home operators and gaming companies. In its simplest form, the sponsor splits the target into two entities, an operating company to run the business and a property company to hold the real estate. The opco leases the real estate from the propco (commonly a "bankruptcy remote" single-purpose entity) and assumes all costs of owning and maintaining the property so that the propco's sole job is to collect rent from the opco and make the mortgage payments.

Opponents argue that these structures are designed principally to "strip" valuable real estate out of a company because, unlike a traditional buyout where the target continues to own the property subject to the lenders' lien, in an opco/propco structure, the opco sells the property, forgoing any residual interest, but still services the mortgage by paying rent to the propco.

There is nothing inherently improper about buyouts with opco/propco structures. Rather, the structure enables companies to access the real estate capital markets, which generally loan more against real estate, at lower interest rates, than standard commercial loans. The structure may also provide tax advantages to propcos that elect to be taxed as REITs.

These theories are at the center of the Chapter 11 of department store chain Mervyn's. In 2004, Mervyn's was sold to a private equity group and split into an opco/propco structure. In 2008, Mervyn's filed Chapter 11 in Delaware. The company promptly sued its lenders, sponsors and parent, alleging that the transactions robbed the company of valuable real estate assets. The lawsuit is in the early stages of pretrial litigation and is being watched closely by sponsors.

Dividend Recapitalizations

Creditors of failed companies also scrutinize prior payments to, or for the benefit of, sponsors, especially dividends financed through recapitalizations. When conditions are right, a company may incur additional debt in order to pay a special dividend, enabling its sponsor to realize a return earlier in the life of its investment. The net effect is that the company takes on more debt and the sponsor recovers some of its investment without diluting its equity.

Dividend recaps exploded in popularity a few years ago, due in part to a reduction in the tax rate for corporate dividends to 15%. Although a relatively new phenomenon, the amounts involved are significant — in 2007, dividends paid from sponsored recaps totaled $49 billion.

Experts now predict that half of all portfolio companies will default on their debt obligations in the next three years.

Opponents argue that a dividend recap weakens a company by adding debt to the balance sheet while cash is "siphoned off" to the sponsor. Those arguments ignore long-standing precedent that it is perfectly appropriate for a subsidiary to declare a dividend for its parent, and doing so by taking on debt is of no moment as long as the dividend is permitted under state law, which generally requires only that the company not be rendered insolvent or close to it.

Although there are few reported lawsuits challenging dividend recaps, we appear poised for an increase, at least until a body of law develops that enables litigants to weigh the merits of their positions. The current benchmark case is the original Chapter 11 of KB Toys in Delaware. In 2000, KB Toys was acquired by sponsors and, in 2002, issued debt in order to pay bonuses and dividends to the sponsors. In 2004, KB Toys filed Chapter 11, following which the sponsors were sued in state court in Delaware and Massachusetts. Both lawsuits alleged that the recap rendered the company insolvent. The lawsuits were settled for an undisclosed sum.

Another example is the Chapter 11 of Powermate in 2008. Unsecured creditors challenged a dividend recap alleging that, following a spike in earnings after Hurricane Katrina, the company, which produces power generators, incurred debt to pay a dividend to its sponsors, rendering it insolvent. The lawsuit was settled for a relatively modest distribution.

Some recaps will be at greater risk than others. The prudent sponsor will ensure that the company is not rendered insolvent in the wake of the dividend payment. Although not required, sponsors may take measures to reduce their risk by, for example, having the transaction approved by independent directors, if available; giving a special committee access to its own legal and financial advisors; and, where the dividend is sufficiently large, obtaining a solvency opinion.

Deepening Insolvency

A third source of potential liability for sponsors is where creditors assert a claim for "deepening insolvency" — that the sponsor wrongfully prolonged the company's life to recoup its investment or collect dividends, to the detriment of creditors. The theory was prevalent a few years ago but lost traction and is no longer recognized as an independent claim by most courts. The theory remains relevant, however, if for no other reason than the size of the damage awards sought, which in almost every case will far exceed the sponsor's investment. Also, deepening insolvency may be the appropriate measure of damages for another claim, such as a breach of fiduciary duty claim. Courts have tended to rein in that use as well; however, in a recent decision that some experts argue may have breathed life back into deepening insolvency, the Delaware bankruptcy court refused to dismiss a trustee's lawsuit against a sponsor that included fiduciary duty claims with deepening insolvency proposed as the measure of damages.

In general, a director owes the corporation and its shareholders a duty of care and duty of loyalty. Once the corporation becomes insolvent, the director's fiduciary duties shift to include the company's creditors. Insolvency in this context means either (a) the company's liabilities exceed the fair value of its assets (the "balance sheet" test) or (b) the company can no longer pay its debts as they come due. In essence, the directors of an insolvent company owe the same fiduciary duties they always owed to the company, but because the company is insolvent, the stakeholders now include creditors. In some states, the shift occurs earlier, when the company enters the "zone of insolvency," but the vitality of that doctrine is in question and, certainly in Delaware, directors owe no fiduciary duties to creditors until the company is insolvent.[4]

The duty of care requires a director to act with the care a prudent person would exercise under similar circumstances. The duty of loyalty obligates a director to put the interests of the corporation above his personal interests (or in this context, the sponsor's interests). The distinction is relevant because, under Delaware law, a corporation's certificate of incorporation can include an exculpation clause that exonerates directors from personal liability for a breach of the duty of care, but not the duty of loyalty. A director's decisions are generally protected by the "business judgment rule," which requires only that the director make decisions on an informed basis, in good faith, and with an honest belief that he or she is acting in the company's best interests. In instances where a director had personal interest in a transaction or lacked independence, the business judgment rule does not apply, and the burden shifts to the director to establish the "intrinsic fairness" of the transaction, which is a much more difficult standard.

In *Brown Schools*, a Chapter 7 trustee sued the sponsor and related parties under various theories, including breach of loyalty. Over several years, the company sold assets and used the proceeds to repay debt and pay fees to the sponsor. The company also granted liens to secure the sponsor's sub-debt. In a decision last year, the court declined to dismiss the lawsuit and left open the possibility that deepening insolvency could be a measure of damages for breach of loyalty claims.[5] The case subsequently went to mediation and settled for $4.75 million.

The lasting impact of *Brown Schools* remains to be seen; notably, the decision was in the context of a motion to dismiss, which required the court to accept the lawsuit's version of the facts as true. Whether the trustee would have prevailed at trial is unknown, and the ruling is probably best confined to its facts. However, it seems clear that, in the right circumstances, courts may still entertain the notion that a sponsor could be liable for damages in excess of its original investment under a theory that it worsened a portfolio company's insolvency.

Conclusion

The wave of portfolio company restructurings is surging ahead and with it, unsecured creditors, faced with the prospects of diminished or no recoveries, are searching for ways to hold sponsors accountable for the companies' financial collapses. The legal theories themselves are not new — fraudulent transfer, illegal dividend, deepening insolvency — but efforts to expand their use to sponsors is new, and should be monitored closely by sponsors and their counsel.

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[4] Delaware also recently clarified that creditors cannot sue directors directly for an alleged breach of their fiduciary duties and must bring such claims, if at all, only as "derivative" claims on behalf of the corporation. *See North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla* 930 A.2d 92, 101-02 (Del. Supr. 2007).

[5] *See Miller v. McCown De Leeum & Co. (In re The Brown Schools, Inc.)*, 386 B.R. 37, 48 (Bankr. D. Del 2008); *but compare In re SI Restructuring, Inc.* (5th Cir. 2008) (rejecting deepening insolvency both as an independent claim and a measure of damages under Texas law).

Dark, But Not Placid, Pools

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The use of dark pools by the buy side is set to grow significantly during 2009, according to a global survey of investors undertaken by Liquidnet, the global institutional marketplace for equities trading.

"The jury is out — very much, I think — on dark pools," SEC Chair Mary Schapiro remarked on CNBC in August. "That's part of the analysis we're going through now and we'll seek public comment broadly." In a June 2009 speech, she expressed an SEC concern that the "lack of transparency" about dark pool executions could "undermine public confidence in the equity markets, particularly if the volume of trading activity in dark pools increases substantially." She also highlighted the "danger that significant private markets may develop that exclude public investors."

In February 2008, the SEC's Director of Trading and Markets, Erik Sirri, spoke of some of the regulatory concerns dark pools are presenting, such as those relating to transparency, fragmentation and fair access. Additionally, the SEC's Director of Division of Investment Management, Andrew Donohue, at a June 2008 speech asked in the context of an investment adviser's use of dark pools: "Is the use of a dark pool appropriate with low commission costs and minimized market impact and information leakage? If so, should the adviser use multiple pools or more aggregated ones? Is algorithmic trading needed to find liquidity? Should research be purchased — if so, which research and in what type of arrangement?"

Such publicly expressed concerns are often harbingers of SEC action. Indeed, the SEC is expected to propose new rules this fall that could reduce the amount of trading done through dark pools and away from the public markets. It has been reported that the SEC will issue both a rule proposal as well as a "concept release" outlining possible changes to the way broker-dealers operate their dark pools. The two most significant changes being considered are expected to be a decrease in the 5% volume threshold for display obligations, and adjustments to the trade-through rule.

Speculation has the SEC reducing the threshold for dark pools to publicly display quotes and provide fair access from 5% to 1 or 2%[1]; and requiring that dark pools record trade executions and disclose more information about their trading activity after a suitable time delay, enabling broker-dealers to know how much of the market in particular securities is trading in particular alternative trading systems ("ATSs"). Further, the trade-through rule may be altered to prevent dark pools (and possibly upstairs desks) from trading at the market's best price by simply matching that price. Instead, those pools would have to take down the available displayed liquidity at the national best bid or offer before trading at that price.[2]

The Rapid Darkening of Liquidity Pools

ATSs are automated screen-based trading systems offering subscribers a variety of services that may not be available in the organized markets. Initially developed to counterbalance exchanges in the era of fixed commissions, ATSs later focused on

[1] Generally, if a dark pool transacts 5% of the average daily volume in a security in four of the last six months on a look-back basis, it must display quotes in that security publicly and provide broad access to its pool.

[2] *See generally*, Nina Mehta, "End of the Line? SEC Targets Dark Pools and Off-Board Trading," *Traders Magazine*, Volume 22, Issue 300 (September 1, 2009).

specialized customers, principally institutional investors and financial intermediaries.

With the advent of algorithmic trading, which utilizes computer software to identify the most profitable trading strategy by setting matrices of timing, prices and order size, electronic trading systems intensified their advantage over manually-driven markets. Many ATSs provide institutional investors with direct access to their trading platforms without the participation of a broker, thus eliminating an additional layer of intermediation as well as further reducing fees. In addition, many ATSs specialize in professional investors wishing to trade in large blocks, thus providing a higher likelihood of matching a large order.

Pension funds, mutual funds, hedge funds and many other big institutional investors also prefer ATSs that offer anonymous trading, thus avoiding the negative repercussions of releasing a large order in the retail market; executing large orders "in the dark" lessens the odds of tipping the market. Their operators say they provide a legitimate service because the execution of large orders is becoming increasingly difficult on normal markets as electronic trading slices orders into ever-smaller sizes, creating an environment where large orders are easily visible to rival traders, and potentially taking months to fully execute.

Dark pools started in the United States some five years ago and now account for approximately 10% of daily trading volume in the United States, the Tabb Group estimates, up from less than 1% in 2003; and total ACS trading accounts for nearly 25% of trading volume. In 1999, ATSs attracted almost 20% of the order flow in Nasdaq stocks. In June 2008, Nasdaq's own market-share in Nasdaq stocks amounted to just 42%.[3] Similarly, the NYSE controlled about 78% of the trading volume in its own stocks until as recently as January 2003; by fall 2008, its market share had fallen to just 25%, largely because of competition by ATSs and Nasdaq.[4]

Goldman Sachs's dark pool, Sigma X, has grown to the seventh-largest trading venue in the United States. Although dark pools have been particularly successful in the United States, they are now expanding into other regions, most recently Asia. Many U.S. dark pools provide trading in stocks listed abroad. Turquoise, the European ATS, will be offering dark pool services along with its traditional order book. To increase their liquidity, some dark pools have announced plans to link up their trading platforms, allowing their clients to access more pools simultaneously.[5] Thus market participants are creating various linkages between "dark" and "light" pools of liquidity, outside of government-mandated connections.

The use of dark pools by the buy side is set to grow significantly during 2009, according to a global survey of investors undertaken by Liquidnet, the global institutional marketplace for equities trading (which has conducted $11 billion of share trades in Asia since its launch there in November 2007). Despite the recent decrease in exchange trade volumes, the report found that the majority of participants globally are planning to increase their use of dark pools, with 54% of those questioned predicting an increase, and only 7% foreseeing a decline in their dark pool volumes. Nearly three-quarters (73%) of European participants questioned plan to increase their use of dark pools this year, compared to 58% in Asia and 52% in North America.

In addition to bridging trading venues, dark pools have contributed to the expansion of trading strategies, particularly through the introduction of two new order types to traditional quoting mechanisms. "Immediate or cancel" ("IOC") orders require immediate execution; any unexecuted part of the order is cancelled if not filled. Accordingly, IOC orders are not quotes because they seek a matching counter-order for their unexecuted portions. The second new type of order plumbs a matching counter-order without posting a quote by signaling an "Indication of Interest" ("IOI") to trade in a certain stock. Some IOIs specify order size or prices, yet many do not. Thus, many institutional investors assert that dark pools are contributing to the increasing sophistication of the modern trading environment.

Current U.S. Regulation-Lite of Dark Pools

Regulatory supervision of electronic trading systems began in 1998 when the SEC adopted Regulation ATS,[6] which requires ATSs to register with the SEC as nation-

[3] Nasdaq Performance Statistics, "Nasdaq Continues to Lead in Matched Market Share of All U.S.-Listed Equities," *available at* http:/nasdaqtrader.com/trader.aspx?id=marketshare.

[4] NYSE Share Volume in NYSE-Listed Securities, *available at* http://media.primezone.com/cache/6948/file/5876.jpg.

[5] *See* Anuj Gangahar, "Banks to Allow Dips into Liquidity Pools," *Fin. Times*, May 20, 2009, at 45.

[6] Regulation ATS, 17 C.F.R. §§ 242.301(a)–(2005).

The SEC is expected to propose new rules this fall that could reduce the amount of trading done through dark pools and away from the public markets. It has been reported that the SEC will issue both a rule proposal as well as a "concept release" outlining possible changes to the way broker-dealers operate their dark pools.

al securities exchanges or as broker-dealers. Most ATSs elected broker-dealer registration, while some merged with regional exchanges or made applications for an exchange license. The SEC requires ATSs registered as broker-dealers to display to an exchange or securities association facility quotes for all stocks for which they handle an average daily trading volume of 5% or more. Moreover, these ATSs must provide other broker-dealers with the opportunity to access their systems and trade against their displayed quotes without charging excessive fees.

In 2005, the SEC adopted Regulation NMS (National Market System), which sets forth detailed rules for the execution of orders originating in multiple trading services in the United States. Regulation NMS leveled the playing field between ATSs and exchanges by requiring that all trading venues ensure the best execution of trades. The changes, which went into effect in December 2006, were a catalyst for the formation of more alternative trading venues, which recognized that by competing on price, orders would gravitate to them.

Currently, dark pools are not required to disclose how they operate or process orders; they do not have to explain bids and offers, as exchanges do not identify trading counterparties. Yet as noted above, the regulatory pH of dark liquidity pools may well be increased.

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INVESTMENT FUNDS *New York Seminar*

Thursday, November 19, 2009

Emerging Managers — Raising a New Fund in the Current Market

Private investment funds have become an established part of the financial industry and an essential arm of the asset management industry. In addition to established firms with demonstrated track records, new emerging managers, including women and minority-owned managers, continue to be established to pursue unique opportunities. Pension plans, asset managers and corporations increasingly use dedicated allocations to identify and support emerging managers to create innovative and cutting-edge partnerships.

The regulatory environment for third-party marketers is simultaneously responding to demands to make the fundraising process more transparent. Placement agents, investors and investment managers will need to evolve and adapt to this new climate.

Tyson Pratcher (Assistant Comptroller, New York State Office of the Comptroller), Joseph Haslip (Assistant Comptroller for Pensions, Office of the New York City Comptroller), Jay Garcia (Partner, Uni-World Capital, L.P.) and Timothy Spangler (Partner, Kaye Scholer LLP) will discuss the latest issues facing emerging managers and the development of the market with respect to third-party marketers.

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4:30 pm Registration
5:00 pm Program
5:50 pm Q&A
6:00 pm Cocktails Reception

You may register online at **www.kayescholer.com** (click on "Events") or send an email to: **seminars@kayescholer.com**.

The European Commission Draft Directive on Alternative Investment Fund Managers: Implications for United States Alternative Investment Fund Managers

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If the Directive is adopted as it is currently written, some critics believe that it will severely restrict U.S. AIFMs from marketing Foreign Funds in the EU.

On April 30, 2009, the European Commission (the "Commission") published, in draft form, its Directive on Alternative Investment Fund Managers (the "Directive"). The Commission stated that the purpose behind the directive is to introduce harmonized requirements for entities engaged in the management and administration of alternative investment funds (labeled by the Commission as Alternative Investment Fund Managers or "AIFMs") in the European Union (the "EU"). However, despite its stated purpose, the Directive will have serious implications for AIFMs around the world ("Foreign AIFMs"), including those AIFMs established in the United States ("U.S. AIFMs").

Scope

EU AIFMs

The Directive governs AIFMs not regulated under the UCITS Directive that are "established in the [EU], [and] provide management services [directly or by delegation] to one of more alternative investment funds" ("Funds") and have assets of more than 100 million or, in the case of a Fund with no leverage and a lock-in period of five years or more, more than 500 million. The term AIFM includes, for example, managers of hedge funds, private equity funds, real property funds and closed-ended funds. The term "EU AIFMs" as used in this article will apply only to those AIFMs that meet these requirements and are subject to the Directive.

Foreign AIFMs

Foreign AIFMs are prohibited by the Directive from managing a Fund located in the EU. Therefore, if a U.S. AIFM desires to manage an EU Fund, it would be required to establish a branch in the EU and comply with the regulations imposed by the Directive on EU AIFMs.

A Foreign AIFM that only manages Funds located outside the EU ("Foreign Funds") and does not market them in the EU will not be subject to the Directive's requirements. However, as discussed below, if a Foreign AIFM desires to market its Foreign Funds in Europe, it must comply with several of the requirements of the Directive.

Domicile of Fund

The Directive focuses purely on AIFMs and will apply regardless of whether the Fund managed by the AIFM is domiciled inside or outside the EU, or whether it belongs to the open-ended or closed-ended type. Therefore, an AIFM established in the EU that manages a Foreign Fund (such as a Cayman-based hedge fund) will be subject to the Directive, unless an exemption applies (for example, if the assets of the Foreign Fund are 100 million or less, or the AIFM concerned is an EU-based credit institution).

Marketing a Foreign Fund in Europe under the Directive

The Directive requires that AIFMs meet certain requirements before they are permitted to market Foreign Funds in the EU. The requirements, as discussed below, are different for EU AIFMs and Foreign AIFMs.

"Marketing" is defined as "any general offering or placement of units or shares in a [Fund] to or with investors domiciled in the [EU] regardless of at whose initiative the offer or placement takes place." The definition, therefore, extends to responding to unsolicited approaches, and if a U.S. AIFM

receives an unsolicited approach from an EU investor, any response will likely be considered "marketing."

Marketing a Foreign Fund by EU AIFMs

Under the Directive, EU AIFMs are permitted to market Foreign Funds to professional investors throughout the entire EU through an "EU Passport," provided that the EU Member State in which the investor is domiciled, has entered into an agreement with the country in which the Foreign Fund is domiciled, based on Article 26 of the OECD Model Tax Convention. The reason for this requirement is to enable an exchange of information regarding tax matters between the two countries; this will help tax authorities within the EU Member State concerned to properly tax professional investors domiciled in that State on their foreign investments.

This requirement, however, only takes effect three years after the Directive comes into force. In the intervening three-year period, EU AIFMs may market Foreign Funds within the EU Member States that will allow it, subject only to the relevant national law.

Marketing a Foreign Fund by U.S. AIFMs

In order for a Foreign AIFM to market Foreign Funds in the EU, five conditions need to be satisfied. In the context of a U.S. AIFM, these conditions are:

(a) the Commission must have determined that the legislation regarding prudential regulation and ongoing supervision in the United States is equivalent to the provisions of the Directive and is effectively enforced;

(b) the Commission must have determined that the United States grants to EU AIFMs comparable access to its domestic market;

(c) the U.S. AIFM must provide the EU Member State in which it applies for authorization with various information, including information on the identities of its shareholders or members that have a direct or indirect holding in the U.S. AIFM that represents 10 percent or more of its capital or voting rights, a program of activity (including details of how the U.S. AIFM intends to comply with provisions of the Directive regarding operating conditions, transparency, and managing and marketing requirements), the characteristics and rules or incorporation information of each Foreign Fund it intends to manage, third-party delegation arrangements, and arrangements for the safekeeping of the assets of the Foreign Fund;

(d) the authorities of the EU Member State in which the U.S. AIFM is applying for authorisation must have entered into a cooperation agreement with the "supervisor" of the U.S. AIFM, which ensures an efficient exchange of all information that is relevant for monitoring the potential implications of the activities of the U.S. AIFM for the stability of systemically relevant financial institutions and the orderly functioning of markets in which the U.S. AIFM is active. The term "supervisor" is not defined, but for U.S. AIFMs it is assumed it will mean the Securities and Exchange Commission ("SEC") (or, in certain cases, the Federal Reserve under the U.S. Department of Treasury proposed reforms). If the U.S. AIFM is not registered with the SEC as an investment adviser or with the Federal Reserve pursuant to the reforms, it appears as though this condition would prohibit that U.S. AIFM from marketing Foreign Funds in the EU; and

(e) the United States must have entered into an agreement based on Article 26 of the OECD Model Tax Convention with the EU Member State in which the U.S. AIFM seeks authorization (compare II.A above).

Like the marketing requirements for Foreign Funds that apply to EU AIFMs, the marketing requirements for Foreign AIFMs do not come into effect until three years after the Directive comes into force. However, whilst an EU AIFM will clearly be able to market Foreign Funds in the EU on a country-by-country basis in that three-year period if local requirements permit, it is uncertain whether a Foreign AIFM will be able to do likewise.

Delegation of Administrative Services

Under Article 18 of the Directive, an EU AIFM may delegate management and administration to third parties within the EU, provided that certain conditions are satisfied. EU AIFMs may also delegate administrative services to third parties outside the EU, subject to the below requirements. However, these requirements only come into effect three years after the Directive comes into force. Until then, it would appear that the extent to which EU AIFMs can delegate their functions to entities outside the EU will depend on the law of the EU Member State in which the AIFM is authorized.

Specifically, in order for an EU AIFM to appoint an administrator established outside the EU, the following conditions must be met: (a) the requirements of Article 18 of the Directive must be satisfied, (b) the administrator must be authorized to provide administration services or be registered in its home country and be subject to prudential supervision, and (c) there must be an appropriate cooperation agreement between the competent authority of the EU AIFM and the supervisory authority of the administrator.

A Foreign AIFM that markets a Foreign Fund within the EU will in effect be subject to the same restrictions as an EU AIFM as regards delegation. If this were not the case, the Commission would not be able to conclude that the legislation regarding prudential regulation and ongoing supervision applicable to the Foreign AIFM was equivalent to the provisions of the Directive (see II.B above).

Appointment of Valuers

The Directive requires an EU AIFM to appoint an independent "Valuer"(which the Directive terms a "valuator") for every Fund that it manages. As in the case of administrators, this job can be delegated to a Valuer outside the

EU, subject to certain requirements, discussed below. Again, these requirements take effect three years after the Directive is effective; and, as in the case of delegating administrative services to entities outside the EU, it would appear that until these requirements come into force, whether an EU AIFM can appoint a Valuer outside the EU will depend on the law of the Member State in which that AIFM is authorized.

Specifically, in order for an EU AIFM to appoint a Valuer established outside the EU: (a) the entity must meet all of the requirements of Article 16 of the Directive, which governs Valuers established within the EU and (b) the Commission must have determined that the valuation standards and rules used by that Valuer are equivalent to those applicable in the EU.

Depositaries

Under Article 17 of the Directive, all depositaries of Funds managed by EU AIFMs must be authorized credit institutions with their registered offices in the EU. In general, depositary tasks may only be delegated to other depositaries. However, in the case of Foreign Funds, Article 38 of the Directive permits delegation to a depositary domiciled outside the EU if the following requirements are met: (a) the sub-depositary must be domiciled in the same country as the Foreign Fund, (b) the Commission must have determined that sub-depositaries in that country are subject to effective prudential regulation and supervision equivalent to that applying in the EU, (c) cooperation between the EU depositary's home state and the foreign country must be ensured, and (d) the Commission must have determined that the foreign country has standards equivalent to those in the EU regarding the prevention of money laundering and terrorist financing.

As with other provisions in the Directive relating to countries outside the EU, this delegation requirement becomes effective three years after the Directive comes into effect. In this case, however, it would appear that until Article 38 comes into force, sub-delegation to a depositary based outside the EU will not be possible, as Article 17 limits delegation to credit institutions based in the EU.

Criticisms of the Directive's Effects on U.S. AIFMs

If the Directive is adopted as it is currently written, some critics believe that it will severely restrict U.S. AIFMs from marketing Foreign Funds in the EU. While the Directive permits U.S. AIFMs to market Foreign Funds in the EU if they meet the requirements discussed above, many of those requirements are based on the activities of the government of the country where the Fund is domiciled, something the AIFMs cannot control. For example, if the Commission determines that the United States does not provide comparable access to its markets for EU AIFMs, all U.S. AIFMs will be prohibited from marketing their Funds in the EU. The only way a U.S. AIFM would be permitted to market its funds in the EU in such circumstances would be to turn itself into an EU AIFM by establishing a presence in the EU and complying with all of the provisions of the Directive. Given that it seems very unlikely that the conditions set out in II.B above will be satisfied for U.S. AIFMs, this may be the only option for a U.S. AIFM that wants to market its Funds to investors in the EU.

If U.S. AIFMs are prohibited from marketing Foreign Funds in the EU, one undesirable consequence is that the United States will then, in turn, reciprocate and lock out EU AIFMs from marketing in that country.

Conclusion

While the current draft of the Directive contains several ambiguities that the Commission needs to clarify, one thing is certain: even though the Directive is a purely European legislation, it will have serious global repercussions. If AIFMs, administrators, Valuers and depositaries based outside the EU desire to continue to do business in the EU under the Directive, they will need to comply, and lobby their governments to comply, with numerous Directive requirements. Therefore, it is important for the worldwide investment community to keep a close watch on the Directive's developments and be prepared if and when it comes into effect.

It is anticipated that a new draft of the Directive will be published in the fall of 2009. While it is unlikely that the draft will eliminate any of the above-discussed requirements, it is believed that it will clarify a number of points. When the draft is finalized, it must then be approved by the European Parliament and the Council, pursuant to the co-decision procedure. It is anticipated that the draft will be the subject of intense debate and negotiation during this procedure. However, if approval is reached by the end of 2009, the Directive would come into force in 2011, with the provisions relating to Foreign Funds and Foreign AIFMs discussed above taking effect from 2014.

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