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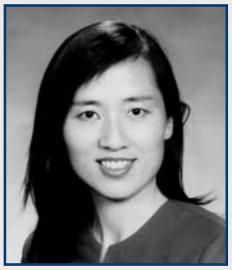
INVESTMENT FUNDS NEWSLETTER

Chinese Private Equity Industry Welcomes New PRC Partnership Law



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The recently amended and restated PRC Partnership Enterprise Law (the "Amended Partnership Law"), one of many legislative efforts to legalize and facilitate the establishment of private equity funds in China, has drawn growing attention within the private equity world. Partnerships under the Amended Partnership Law have been quickly accepted as a new form of business organization. On June 26, 2007, less than a month after the Amended Partnership Law became effective, the first limited partnership, South Sea Growth Fund LLP, was established in Shenzhen and raised over RMB1.6 billion at its first stage of fund raising.

The PRC Partnership Enterprise Law was originally promulgated on February 23, 1997, long before the private equity wave reached the shores of China. The Law contained several features that are particularly discouraging to private equity funds. First, only natural persons were able to become partners in a partnership. Second, partners assumed unlimited liability for the debts of the partnership. Third, the partnership and its partners were subject to double taxation, including a 33% corporate income tax on the partnership and a 5-35% individual income tax on its partners.

The Amended Partnership Law has made three major breakthroughs. First, any natural person, legal person or other institution may now form a partnership. While wholly state-funded companies, publicly-listed companies, institutions for public welfare and social organizations may not be general partners, other institutional investors that are private equity funds' primary investors are now eligible to become partners in private equity funds.

The second breakthrough is the creation of limited liability partnerships, each consisting of at least one general partner and up to 50 limited partners. A general partner, which can be a corporation, assumes unlimited liability while the liability of limited partners is capped by their capital contribution to the partnership. A limited partnership, in the case of private equity funds, will combine the management skills of a general partner with the capital of institutional investors as limited partners. The creation of limited partnerships is expected to enhance the development of onshore investment funds and reflects China's determination to cultivate its own private equity industry.

The Amended Partnership Law further provides for the establishment, capital contribution, operation, distribution and bankruptcy of limited partnerships. In addition to certain standard terms, partnership agreements for limited liability partnerships are required to include the names and addresses of general and limited partners, the procedures to select general partners, the authority and obligations of general partners, the replacement

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of general partners, and the conditions and procedures for a limited partner to join and/or withdraw from the partnership.

With regard to the operation of a partnership, a general partner would manage the operation of limited partnerships and may charge a fee for its management services in accordance with the relevant partnership agreement. Limited partners are prohibited from managing or representing the partnership, but they can participate in certain activities, including making decisions concerning the admission or withdrawal of a general partner, making a proposal on the management of the partnership, selecting the partnership's certified public accountant, reviewing the partnership's financial reports, and acting as a guarantor to the partnership as permitted by law.

Going forward, the pass-through tax treatment may be applicable to foreign-invested partnerships as well.

Limited partners can make cash or in-kind capital contributions to a partnership. A limited partner's interest in a partnership is assignable and may be pledged as security in other transactions unless otherwise restricted from doing so in the relevant partnership agreement. Likewise, a limited partner may transfer its interest in a limited partnership to a third party upon 30-day notice to the other partners.

The third breakthrough is the elimination of double taxation by taxing partnerships on a pass-through basis. Under Article 6 of the Amended Partnership Law, partners are responsible for their individual income taxes in association with the operation of a partnership, while the partnership itself is exempt from corporate level income tax. However, at this time only those partnerships established in China by Chinese enterprises and/or individuals can enjoy the pass-through tax benefit, since the Amended Partnership Law is applicable only to partnerships established within China by Chinese enterprises and/or individuals.

Going forward, the pass-through tax treatment may be applicable to foreign-invested partnerships as well. The Regulations on Management of Foreign-Invested Partnerships (the "FIP Regulations") currently being drafted are applicable to partnerships established (i) jointly by foreign natural persons, legal persons or other business entities and Chinese natural persons, legal persons or other business entities; or (ii) by two or more foreign natural persons, legal persons or other business entities.

Despite the favorable pass-through tax treatment provided in the Amended Partnership Law and proposed in the FIP Regulations, this tax benefit, however, is not available to most of the private equity funds currently investing in China. At present, a majority of the private equity funds in China have been established offshore in tax-efficient jurisdictions such as the Cayman Islands. These partnerships are not governed by the Amended Partnership Law and, therefore, cannot enjoy the pass-through tax benefit. Furthermore, in the absence of any regulations that authorize the establishment of the private equity funds in China, it remains questionable whether or not a private equity fund can be legally established in China to raise Renminbi denominated funds and, consequently, whether or not the established funds may enjoy the pass-through tax benefit.

The Amended Partnership Law provides a legal building block for China's domestic private equity industry and reflects China's ambition to build a home-grown private equity industry. In tandem with the enactment of the Amended Partnership Law, the Chinese government also plans to encourage domestic listing of private equity-invested companies by adjusting listing requirements and simplifying listing procedures. All such efforts reflect the intent of the Chinese government to keep economic opportunities inside China. These efforts are in contrast to the attempt made at the same time, as reflected in the newly issued Regulations on the Acquisition of Domestic Enterprises by Foreign Investors (the "M&A Regulations"), to discourage foreign-owned offshore private equity funds to invest in China. The M&A Regulations have imposed stringent restrictions on the practice of off-shore restructuring, which prior to the promulgation of the M&A Regulations had been the predominant structure model among foreign-owned private equity funds to facilitate investment in and exit from China, since China's capital market is largely closed to partially or wholly foreign-owned companies.

To complete the legal framework for China's private equity industry to take off, a specific law or regulations on the establishment, operation and exit of private equity funds are also needed. At this time, the Regulations on Private Equity Funds is in its final drafting stage. The question remains as to whether or not foreign companies may be permitted to establish private equity partnerships in China and raise Renminbi denominated funds.

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Hedge Funds in Court: Litigation Issues Arising from Fund Failures

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Among the thousands of hedge funds presently operating in the United States, some of those that speculated on the subprime market will have suffered mortal blows, and it is only a matter of time before certain funds are forced to liquidate what assets remain in them. Collapse – and attendant dishonored redemption requests – invites litigation. However, the litigation that is likely to come is not unprecedented. Indeed, the litigation that has already commenced in connection with the subprime collapse resembles the litigation that has accompanied previous noteworthy collapses in the financial services industry.

Except in cases of egregious fraud, litigation against defunct hedge funds, whether brought by regulators or by civil litigants, arises most readily out of the offering documents and private placement memoranda originally establishing those funds. The claims in such cases are rooted in allegations of misrepresentations made by those funds, and generally ground themselves on an alleged divergence between the representations made to induce investment in the funds and the manner in which the funds were actually run. The underlying claims may involve allegations that a fund misrepresented the risk that would be involved in its investment choices, departed from its announced investment strategy, failed to adequately diversify its investments, failed to invest with prudence, and the like. Such causes of action may be cast as claims for fraud, fraudulent inducement, breach of fiduciary duty, negligent misrepresentation and gross negligence.

The collapse of the Amaranth hedge fund, a year shy of the present subprime crisis, gave rise to just such allegations. In *San Diego County Employees Retirement Association v. Maounis*, 07-CV2618 (S.D.N.Y. March 29, 2007), a pension fund that had invested in the collapsed Amaranth fund claimed that defendant hedge fund operators misrepresented their fund as "multi-strategy" when it actually allegedly operated "as a single-strategy natural gas fund that took very large and highly leveraged gambles," and "recklessly failed to apply even basic risk management techniques and controls to these gambles." The complaint alleged that these misrepresentations induced plaintiff to invest, and lose, $175 million. While plaintiff's chances of recouping its investment from the fund itself were low, the lawsuit also targeted the fund's principals as an alternate source of recovery.

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Any given fund's litigation exposure will depend in great measure on the investment parameters established for its managers in its offering and promotional materials. Hedge funds by their very nature are risky vehicles for sophisticated investors; hence the courts will not be sympathetic to claims based simply on unanticipated losses, absent serious misrepresentation or breach of duty. Some fund managers are restricted with respect to their investment classes, margin levels, risk appetites or position sizes; others obtain more open-ended mandates, giving them nearly limitless freedom in their investment choices, so that they can do more or less anything short of playing the horses. Claims based on a disparity between what the offering documents advertise and what the fund manager actually did are difficult to sustain unless the offering documents have meaningfully restricted that manager's available strategies or unless the manager truly crossed the line between reasoned investing and recklessness. It is quite difficult to successfully sue a fund manager for exercising his discretion where that discretion was limitless to begin with.

As the effects of the current subprime crisis are manifested with greater and greater force, stresses in the market will unmask a number of fraudsters. Those stresses will also push many funds with marginal returns into liquidation. Hedge funds, however, are simply not structured like corporations, and for this reason, even when they collapse, they are not susceptible to the same litigation pressures as faltering corporations. In a typical dissolution of a fund, a manager's record has been unsuccessful and investors pull their money or have it returned to them pro rata, leaving nothing behind. There are a limited number of investors and there is less money to go around than everyone had hoped. Hedge fund investors are by definition sophisticated and recognize that litigating over what money remains would be fruitless and unsatisfying. Unlike a securities class action against a corporation, which delivers to former investors some portion of the future earnings of the corporation based on alleged misrepresentations that took place in the past, no such forward-looking recovery is available to investors who have lost money in a hedge fund. A collapsing hedge fund is not a going concern; it will not be making widgets tomorrow with which to pay jilted investors today. Nor do hedge funds typically have available to them D&O insurance policies that can fund the defense and settlement of securities fraud cases against corporations and their officers and directors. In the worst of cases, the distribution of the remaining assets of a hedge fund resembles a bankruptcy liquidation — not a reorganization – proceeding, and sophisticated investors quickly understand that litigation against the hedge fund itself will not enlarge the available pot of funds, but merely divert some portion of the remaining assets from investors to litigators.

Even where a hedge fund collapses amid substantial allegations of fraud, the funds available for recompensing investors will not, in simple cases, be at all expanded by litigation. Where a U.S.-based hedge fund manager has stepped over the line into criminality or veered off the deep end into gaudy insanity, the SEC will step in and appoint a receiver to preserve remaining assets and oversee the orderly unwinding of the fund. The ultimate goal of the receivership is to locate and preserve as much of the estate as possible for investors. The goal of preservation is largely fulfilled by the appointment of a fiduciary in place of a fraudster. But if the operator is himself insolvent (as will often be the case in the wake of a fund's collapse) and there were no third parties involved in the fraud, litigation may do more harm than good – except perhaps for the plaintiffs' lawyers.

In many instances, the parties with the greatest litigation risk are in fact not the hedge funds that teeter and collapse, but rather the third-party institutions that get caught standing near the rubble. Such third parties include prime brokers, law firms, consultants and auditors.

Occasionally, a fund that has lost a great deal of its value enters its death throes and, in his last desperate flailing weeks, a fund manager funnels money to favored investors at the expense of less favored investors. One alleged species of this case was addressed earlier this year in *In re: Manhattan Inv. Fund Ltd.,* 359 B.R. 510 (Bankr. S.D.N.Y. 2007). In that decision, Judge Lifland found that a payment made to Bear Stearns in its capacity as prime broker shortly before the collapse of the Manhattan Investment Fund was a fraudulent transfer recoverable by the bankruptcy trustee.

In many instances, the parties with the greatest litigation risk are in fact not the hedge funds that teeter and collapse, but rather the third-party institutions that get caught standing near the rubble. Such third parties include prime brokers, law firms, consultants and auditors. The collapse of the Wood River hedge funds in 2005 and the subsequent guilty plea of its manager, John Whittier, led to two lawsuits against a number of such third parties, both of which are presently being litigated. Mr. Whittier, despite offering document limitations setting a 10% maximum exposure to a single stock, invested nearly all of the funds' capital in a single stock. Although he is forfeiting to the government virtually all his assets on the way to prison, those assets are a drop in the bucket of investor losses. As a result, investors have sued UBS, the funds' prime broker, in New York state court; the suit against UBS is presently the subject of a motion to dismiss. Investors also sued Seward

& Kissel, the funds' law firm, along with the funds' accountants and administrator, also in New York state court; the denial of Seward & Kissel's motion to dismiss is presently on appeal.[1]

Consultants have been targeted in connection with other great collapses. In *DePauw University v. Hennessee Group LLC, et al.,* 2:05-cv-0249-RLY-WGH (S.D. Indiana Oct. 12, 2005), the University sued its investment advisor alleging that the advisor had advised it to invest in the Bayou No Leverage Fund LLC without satisfactorily investigating that fund, and that this negligent advice amounts to fraud, breach of fiduciary duty, violation of the Securities Exchange Act and breach of the Advisory Agreement. In *Atwater, et al. v. The National Football League Players Assoc.,* 1:06-CV-1510 JEC (N.D. Georgia Jan. 23, 2006), seven current and former football players sued the NFL for recommending investment with a fund manager allegedly without screening properly that fund manager. In both cases, the underlying fund collapsed amid charges of outright fraud, and in both cases, the plaintiff investors hope to recover from third parties what they almost certainly cannot recover fully from the distribution of the fund's diminished assets. Each of these defendants potentially has deep enough pockets to remunerate plaintiffs for their losses, and the claims, while grounded on fiduciary duties running from the consultants to the disappointed investors, may turn at least in part on the proximity of the defendants to the fraud, their knowledge, conscious avoidance, or negligence in failing to discover the fraud, their facilitation of the fraud, their compounding of the fraud, and the like.

The rise in the amount of public money invested in hedge funds can lead to litigation where the plaintiffs are not entirely motivated by an expectation of return, but rather, by less tangible concerns. However meritorious the litigation brought by the San Diego pension fund against the principals of Amaranth (discussed above), one suspects that beyond the desire for compensation of the pension fund's losses, the lawsuit was initiated at least in part to demonstrate to the roughly 33,000 present and former city workers whose retirement benefits depend on the San Diego pension fund, as well as to the voters of San Diego, that the evaporation of $175 million from that fund will not be taken lightly. In this sphere, as in others, even where a plaintiff's chances of a positive recovery in a litigation are not overwhelming, litigation may still be commenced, because even a modest recovery after a vigorous and expensive contest, properly ballyhooed, may salve a well-publicized political embarrassment.

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The German Private Equity Act(s): Two Are Less Than One

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For the first time, the law will define the "acting in concert" as cooperation between the shareholders and a third party regarding an act related to the company, which may permanently or significantly influence the operational purpose of the company.

The German Government has proposed new investment legislation, consisting of various acts, two of which may have a significant impact on the private equity investment environment in Germany. Unfortunately, the current proposals attempt to make an untenable distinction between "good" funds and "bad" funds, and, as a result, will leave the private equity industry ultimately unsatisfied.

The Risk Limitation Act

The proposed Risk Limitation Act will increase the transparency of investments in German companies in order to provide better information of shareholders, thus limiting the potential risk of their investments. For the first time, the law will define the "acting in concert" as cooperation between the shareholders and a third party regarding an act related to the company, which may permanently or significantly influence the operational purpose of the company.

Since the acting in concert may influence the number of (additional) shares held – and therefore the obligation to report the participation – this definition may help facilitate a better understanding of this obligation, even if some points remain unclear in the definition, *e.g.*, the meaning of "significant" influence on the company's purposes. The definition shall also be applicable for purposes of the German Securities Acquisition and Takeover Act. According to this Act, an "acting in concert" results in an increase in the number of shares and thus may lead to an obligatory tender offer.

Under the Risk Limitation Act, the information requirements for major participations in publicly listed companies would be enlarged. Currently, participation in shares of a company is considered separately from other financial instruments. This approach is seen as insufficient to inform the company and other shareholders about the influence exerted on the company; thus, the proposal provides that all participations will be considered together. Consequently, the obligation to report the participation (even now applicable for participations above 3%) would be extended.

In addition, the material substance required under the new publication guidelines would also be expanded. The shareholder whose participation exceeds 10% of the shares would be obliged to inform the company in detail about the excess amount within ten trading days' notice. The information must include:

- the purpose of the participation, *i.e.*, whether the participation is of a strategic or merely financial kind;
- a statement as to whether the shareholder intends to acquire further voting rights within the next twelve months;
- a statement as to whether the shareholder intends to achieve control over the company (which is assumed at a participation level of at least 30%);
- a statement as to whether the shareholder intends to influence the composition of the management or supervisory board;
- a statement as to whether the shareholder intends to change any aspect of the company's capital structure, *e.g.*, the debt/equity ratio or the policy of dividends payment; and
- the source of money used to acquire the participation, *i.e.*, the respective debt/equity ratio.

Information may be withheld if the company does not ask for it. Any change of the shareholder's intention must be reported to the company immediately.

In addition, the sanctions for breaches of this obligation will also be expanded. Currently, a shareholder can acquire shares and inform the company just prior to the shareholders' meeting without worrying that his voting rights might be affected. The proposed changes provide that the voting rights will be excluded not only for the silence period, but also for an additional six months following the notification.

If the company has issued registered shares, the owner currently can circumvent his entry in the register by installing a nominee shareholder. The proposal suggests that this procedure of "street name" entries negatively affects the company, and thus, provides that in the future, no rights in connection with the shares can be exercised until the economic owner of the shares is registered.

It is currently discussed that the information rights currently applying only to the employees of publicly listed companies shall be granted as well to the employees of non-listed companies where the control threshold is exceeded.

The Venture Capital Act

The Government also plans a Venture Capital Act that would automatically free early-stage funds from the German trade tax. To gain trade tax exemption status, funds must invest in target companies that fulfill the following requirements:

- the registered office must be in a member state of the European Union or the European Economic Area;
- the company's equity capital (including capital reserves etc.) must not exceed €20 million;
- the company must not have existed for more than 10 years; and
- the company's shares must not be publicly listed.

In addition, the fund itself has to meet the following requirements:

- the fund's purpose must be defined as the acquisition, holding, management and sale of participations in target companies;
- the registered office must be in Germany;
- the fund's share capital must be at least €1 million, 25% of which must be contributed prior to approval by the authorities, and the rest must be contributed within 12 months after the approval; and
- the company must have at least two managing directors, both of whom are reliable and have a proven track record in the company's business.

The venture capital company will then be allowed:

- to acquire, hold, manage and sell participations in target companies' shares according to the investment law and hold bank accounts;
- to render advice to the target companies in which it is invested; and
- to grant loans to target companies in which it is invested.

However, the venture capital company also must meet some requirements regarding its minimum and maximum participation in target companies:

- the investment in target companies must comprise at least 70% of the venture capital company's overall investments;
- a participation in a target company must be sold within 15 years, otherwise the target company will no longer fall under this definition;
- a company is only considered a target company up to (a further) three years following a listing; and
- a venture capital company's participation in a target company is limited to 90% of target's shares.

Venture capital companies will need the approval of the Federal Financial Supervisory Authority, which is also responsible for the ongoing supervision of the venture capital company.

Outlook

Germany has been waiting for a general Private Equity Act to include all basic rules affecting the fund structure and subsequent investment of a private equity fund in Germany. Motivated by a questionable differentiation between "good" venture capital funds and "bad" buyout funds, the preliminary results of the legislation process are a number of rules that will not improve the environment for later-stage investments and will grant only small relief for early-stage investments. This is, nevertheless, a step in the right direction, and hopefully the final rules will make the German legal environment more competitive.

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U.K. Hedge Fund Industry Proposes Increased Disclosure

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By increasing the amount of reliable knowledge about what the hedge fund industry actually does, it is hoped that a more informed general view will result – a process the HFWG characterizes as "enlightened self-interest."

On October 10, 2007, the Hedge Fund Working Group ("HFWG"), representing 14 leading hedge fund managers based mainly in the U.K., published a consultation paper on hedge fund standards. Consultation runs until December 14, 2007 and a final report is planned for January 2008.

The consultation paper is in two parts. The first, containing a summary of the proposed standards, is addressed to a general audience. The second, designed for those with a professional interest in the sector, contains the detailed standards. Together, the two parts contain thirty questions on which responses are sought.

The proposed new standards focus on five "areas of concern:" disclosure, valuation, risk, fund governance and activism. The HFWG has also recommended that hedge fund managers disclose more information about themselves on their websites and that more information about the industry be made available collectively to the wider public. By increasing the amount of reliable knowledge about what the hedge fund industry actually does, it is hoped that a more informed general view will result – a process the HFWG characterizes as "enlightened self-interest."

The main best practice standards in the consultation paper include:

- **Disclosure.** Managers should carefully consider the appropriate level of disclosure in fund documents, the appropriate mechanism for changing the fund's investment policy, and whether commercial terms are disclosed in sufficient detail to enable investors to make informed investment decisions.
- **Valuation.** Managers should ensure that the methodology for valuing complex assets is robust and transparent, and that the presence of illiquid and hard-to-value assets in the portfolio is disclosed, as well as any conflicts of interest in the valuation process.
- **Risk management.** Managers should develop a comprehensive approach to dealing with risk, with particular emphasis on liquidity, so that they are able to cope with unexpected events and stresses. The stress on liquidity is particularly timely, given the current credit conditions.
- **Fund governance.** Managers should ensure that adequate structures are in place to handle potential conflicts between managers and investors, to enable the fund governing body to act with appropriate independence and to comply with appropriate corporate governance principles.
- **Activism.** The HFWG recommends that regulators should as a general rule require all investors to disclose their interest in companies through holding derivatives such as contracts for differences (CFDs); this currently occurs in the U.K. only in a bid situation under the rules of the Takeover Panel. Managers should also develop proxy voting policies and they should not vote in respect of borrowed shares where they have no underlying economic interest.

The HFWG also proposes setting up a board of trustees to "own" the standards. The board would consist of persons with the experience and *gravitas* to command respect among the industry and its stakeholders and would assume responsibility for the standards and for updating them in the future. However, the HFWG is at pains to stress that the board would not act as a regulator. The only sanction the board would have would be to publicly comment on non-conformity with the standards.

In the wider context, the HFWG initiative needs to be considered alongside similar processes in the U.S., including the deliberations on hedge funds of the President's Working Group on Financial Markets (in particular, that Group's recent creation of an Asset Manager Committee focusing initially on practices for hedge fund managers). Hedge funds operate globally and, ultimately, a global standard of disclosure will need to be agreed upon. Indeed, the HFWG's consultation paper draws attention to the global dimension and the desirability of adapting the HFWG best practice standards to global application. It is encouraging to note that the chairman of the HFWG, Sir Andrew Large, has already met with the president of the Managed Funds Association ("MFA") in the United States and the Chief Executive Officer of the Alternative Investment Management Association ("AIMA") in the United Kingdom for discussions on a transatlantic approach to establishing industry best practice.

The creation of a board of trustees will inevitably require a permanent or semi-permanent secretariat to service the process. This will need to be paid for, in whole or in part, by the industry itself, though it may be possible for bodies already in existence, such as AIMA, to carry out some or all of the functions required.

As Sir Andrew notes in his foreword, the report is much needed. There is widespread ignorance about the operation of hedge funds (this is assisted by the difficulty of defining precisely what a hedge fund is, as the HFWG itself notes), and a "code of conduct" consisting of best practice standards embracing greater openness and transparency is the industry's best defence against any attempts to impose a more rigid and restrictive form of regulation on it. As the HWFG also notes, however, it is wrong to regard the hedge fund industry in the U.K. as unregulated, since all U.K.-based hedge fund managers are subject to the rules of the Financial Services Authority ("FSA"). There are, regardless, two surprising omissions from the consultation paper, though one is admittedly beyond the HFWG's control.

First, the standards are expressly linked to the FSA's Principles for Businesses. This is sensible, since at this stage they are drafted primarily with U.K.-regulated hedge fund managers in mind. But nowhere in either part of the consultation paper is there any reference to the coming into force, on November 1, 2007, of the new FSA conduct of business rules that implement the Markets in Financial Instruments Directive ("MiFID"). MiFID will have a significant effect on the workings of regulated hedge fund managers across the European Union, as the guidance note produced by AIMA for its members indicates. In particular, MiFID has things to say relating to (i) risk management, (ii) fair, clear and not misleading communications, (iii) conflicts of interest, and (iv) outsourcing that are directly relevant to the issues examined by the HFWG. It would surely have been useful to firms to see how the HFWG standards and the MiFID-based FSA rules are meant to interact.

Second, given that the HFWG clearly hopes that these best practice standards will be adopted by the industry generally, it is unfortunate that the standards will not be confirmed by the FSA as part of its industry guidance confirmation process. If the FSA had confirmed that it would take the HFWG standards into account when exercising its functions, that would effectively have meant that compliance with the HFWG standards would have been regarded by the FSA as compliance with the underlying regulatory obligation. While that might have required the standards to be recast, FSA confirmation could only have assisted the adoption of the standards by the hedge fund industry generally. However, since major hedge fund managers are represented on the HFWG, it may be that the HWFG is hoping that peer pressure will lead to the standards being widely adopted on a "comply or explain" basis.

It remains to be seen how large an impact the HFWG proposals, if implemented, will have on the industry. To a large extent, as the consultation paper acknowledges, the proposals build on industry best practice. One clear possibility is that the emphasis the proposed standards place on the ability to manage risk will further concentrate business in the hands of the larger firms, as being better able than smaller firms to devote the necessary resources to implementing appropriate systems and controls, though the HFWG sees the emphasis on disclosure, rather than prescriptive operational guidelines, as assisting smaller firms and new market entrants. However, the fact that disclosure is at the root of all the HFWG's recommendations is likely both to counter general criticism of the secrecy with which hedge fund management is conducted and result in investors obtaining more information relevant to their investments. These are outcomes which few could criticize.

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The Attack on Carried Interest: U.S. and U.K. Proposals to Change the Way Sponsors of Private Equity Funds are Taxed

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The tax treatment of private equity funds – in particular, how to tax the carried interest earned by the managers, or "sponsors," of these funds – has been the subject of a good deal of recent scrutiny in both the U.K. and the U.S. The carried interest (or "carry" as it is often referred to) is the share of the gains realized from a fund's underlying investments to which the sponsors are entitled. The percentage of carry assigned to the sponsors is typically 20% of the overall gain after return of capital to investors. To a large extent, the debate on both sides of the Atlantic centers on the appropriate tax rate that should be paid by sponsors, which in part depends on whether the carry is viewed as a return on a successful capital investment, or as deferred consideration for investment management services successfully performed.

In the U.K., agreement was reached in 1987 between the then U.K. Inland Revenue (now HM Revenue & Customs) and the British Venture Capital Association ("BVCA") that carried interest should be taxed as capital.[1] The subsequent introduction of taper relief in 1998, coupled with the 10% capital gains tax rate available since 2002 for the disposal of business assets held for two years (including investments in unlisted companies), meant that carried interest was usually taxed at 10%. Further, U.K. resident but non-U.K. domiciled sponsors could potentially avail themselves of the remittance basis for non-U.K. investments held through offshore carry partnerships and thereby avoid U.K. tax on the realization of carry altogether, provided the carry gains were not brought into the U.K. In the U.S., capital treatment has also been available for the carried interest in that, so long as underlying fund investments are held for more than one year, gains on realization of the carry are currently subject to the 15% long term capital gains rate. This follows from basic U.S. tax rules applicable to entities such as private equity funds, which are (or are treated as) partnerships or "flow-through" entities for tax purposes.

An unusual feature of the present debate is that the question as to how carried interest should be taxed is currently the subject of intense debate on both sides of the Atlantic. The underlying philosophical question is essentially the same – should the carry be taxed as capital or as ordinary income, and in either case, at what tax rate? The arguments for and against either case are well rehearsed and have received ample reporting in the general and specialist press. This article focuses on the different legal proposals being discussed in the U.K. and U.S. that would impact the tax treatment of the carry, and evaluate their relative merits and shortcomings.

The underlying philosophical question is essentially the same – should the carry be taxed as capital or as ordinary income, and in either case, at what tax rate?

The U.S. Debate

A number of legislative proposals impacting private equity funds have been introduced by the U.S. Congress over the past few months, beginning in the wake of the

[1] The BVCA Statement approved by the Inland Revenue and the Department of Trade and Industry on the use of limited partnerships as venture capital investment funds (May 26, 1987).

Fortress and Blackstone flotations last June and, most recently, by inclusion in a major tax bill introduced in October. Two of these proposals are specifically designed to change tax treatment of sponsors of private equity and hedge funds.

The most talked about measure was initially introduced in June 2007 and has now been included, as a major revenue raiser, in bills introduced in October. This measure (the "Carried Interest Proposal") is aimed specifically at eligible carried interests held by sponsors. Under the Carried Interest Proposal, income from any "investment services partnership interest" (and any gain on disposition of such an interest) would be treated as ordinary income from the performance of services, taxable at ordinary income rates (currently 35%), rather than as capital gain (currently taxed at 15%), regardless of the source of income earned. An "investment services partnership interest" would be defined as any interest in a partnership held by any person, if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quality of services to the partnership consisting of investment, valuation and related advice in respect of any "specified asset." "Specified assets" include securities, real estate, commodities, or options and derivative contracts with respect thereto. A limited exception would preserve the potential for capital gain treatment on income representing a "reasonable" return on invested capital. Harsh penalties would apply in connection with underpayments of tax attributable to avoidance of these new provisions.

Enactment of the Carried Interest Proposal or similar legislation would have a much broader impact than a prior proposal, also originally introduced in June 2007, that would have taxed publicly traded fund managers, such as Blackstone and Fortress, as corporations (the "PTP Proposal"). Unlike the PTP Proposal, the Carried Interest Proposal covers interests in a wide range of partnerships, whether or not the fund is publicly traded. Moreover, by treating income from an "investment services partnership" as services income, the Carried Interest Proposal effectively would render the PTP Proposal provision unnecessary, *i.e.,* a publicly traded partnership where more than 10% of the gross income was derived from "carried interests" in funds would automatically be taxed as a corporation.

A second proposal, which is intended to prevent sponsors from using offshore tax haven corporations and other structures to defer taxes on compensation received for providing investment services, was also included in the bills introduced in October. Under current law, individuals can defer paying tax on compensation until compensation is paid, so long as the corporate payor defers its deduction. There is no offsetting deduction to be deferred where compensation payment is made by an offshore tax haven corporation or partnership. Substantially all of the income allocated to tax-exempt organizations or non-U.S. persons is not subject to tax. Many funds have used structures whereby management fees are paid by funds to an offshore entity; this entity defers payment to the ultimate U.S. taxpayer/principals.

The proposal, which would be effective for taxable years beginning after December 31, 2007, would require deferred compensation owed by such offshore entities for investment services performed by the principals (defined, for this purpose, by reference to the "carried interest" provisions described above) to be taken into income as it accrues, regardless of timing of payment, so long as the entitlement to the fee is not conditioned upon future performance of substantial services. Any amounts owed but not currently ascertainable would be taken into income when ascertainable, with an interest charge imposed on the deferred tax liability.

The U.K. Debate

Analogous to the U.S. devlopements described above, the principal industry concern in the U.K. had been that the 1987 agreement between the U.K. Inland Revenue and the BVCA would be revoked and that carried interest would be taxed as ordinary, albeit deferred, income when received. The 1987 agreement had been implicitly reaffirmed in 2003 when the treatment of carried interest and co-investments for sponsors under the restricted employment securities regime of Schedule 22, Income Tax (Employment and Pensions) Act 2003 was agreed in two further Memoranda.[2]

The recent high profile media coverage of the discussions in the U.K. centered around the 10% tax rate paid by sponsors, and the political pressure led many observers to argue that some change was inevitable.[3] In the Pre-Budget

[2] The Memorandum of Understanding between the BVCA and Inland Revenue on the income tax treatment of managers' equity investments in venture capital and private equity-backed companies (July 25, 2003), and the Memorandum of Understanding between the BVCA and Inland Revenue on the income tax treatment of Venture Capital and Private Equity Limited Partnerships and Carried Interest (July 25, 2003).

[3] While largely correct for the treatment of carried interest, the U.K. press coverage was occasionally misleading in that, e.g., when composing headline tax rates, it failed to mention the annual management fees payable by the fund to sponsors, which is subject to income tax, typically at the higher tax rate of 40%.

Report of October 10, 2007, the U.K. Chancellor announced the introduction of a flat capital gains tax rate of 18%, together with the abolition of taper relief and indexation allowance, beginning April 6, 2008. The Pre-Budget Report did not suggest, however, that either the 1987 or 2003 Memoranda were to be revoked. As a result, carried interest would still be taxed as a capital gain, albeit at 18% for disposals made after April 6, 2008. The upside of the proposed abolition of taper relief means that the 18% rate would be available for *any* capital gains realized in respect of carried interest after April 6, 2008. Thus, the two-year holding period before the maximum business assets taper relief rate applies, the arguments as to when the taper relief clock starts (*e.g.*, on allocation of the carry, or on passing the hurdle), and the requirement for the investee securities to be "unlisted" would no longer be of concern.

A second change announced in the Pre-Budget Report that could impact the private equity industry involved changing the taxation of non-domiciliaries living in the U.K. Historically, residents of the U.K. who were domiciled in another jurisdiction benefited from the remittance basis of taxation, whereby they were only taxed on non-U.K. gains and income to the extent the relevant proceeds were brought into the U.K. U.K. resident sponsors of private equity funds who were non-domiciliaries could in principle benefit from the remittance basis for carried interest gains where the fund investments were held through an offshore carry partnership and the investments are non-U.K. Under the proposed changes, the remittance basis of taxation would continue to be available, including to sponsors, in return for a flat annual tax payment of £30,000 – applicable only where non-domiciled sponsors have been resident in the U.K. for seven years (until such time, the remittance basis would be available without any payment). While the U.K. government is currently consulting on the precise changes to be introduced (which have given rise to considerable concern), it is unlikely that the levy of an annual charge will be dropped altogether. Nevertheless, purely from a carry perspective, in many circumstances, £30,000 will seem a good investment in order to obtain remittance-based treatment.

Conclusion

In the U.S., private equity industry groups are vigorously fighting recent Congressional proposals described above. It is difficult to say how likely enactment of the U.S. proposals is, especially with Congress shortly headed toward holiday recess. There is a fair chance that some change to the taxation of carried interests and related fees will make it into the law in the near future. However, other potential tax developments, including, for example, a potential increase in the capital gain rates should the Democrats capture the White House in the election next year, could change the backdrop against which the carried interest debate is carried out. The U.K. is at present one step ahead. The changes announced in the Pre-Budget Report *will* become law unless the current lobbying by British industry groups leads to an either full or partial reversal. It is fair to assume for now, however, that a full reversal in relation to the capital gains tax rate payable by sponsors of private equity funds is unlikely.

In both the U.S. and the U.K., a similar problem is facing the political and revenue authorities. They must balance a generous capital gains tax regime that sought to promote entrepreneurialism and the taking of investment risk and which, somewhat unintentionally, has enabled the private equity industry to become a spectacular success against the growing uneasiness at the financial inequalities created and the ever-present need to raise further revenue. The competing financial and political interests make it difficult to predict the outcome. Hopefully, for the sake of both countries, with New York and London engaged in a battle for top spot among the world's financial centres, over-zealous changes will not lead to a lucky third city emerging as the ultimate winner.

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